DOCKET

(12)

No. 88-1319-CFX
Status: GRANTED

Title: Commissioner of Internal Revenue, Petitioner
v.
Indianapolis Power & Light Company

Docketed:
February 7, 1989

Court: United States Court of Appeals
for the Seventh Circuit

Counsel for petitioner: Solicitor General

Counsel for respondent: Stroble,Larry

Entry	Date	Note	Proceedings and Orders
1	Dec 9 1988	G	Application (A88-466) to extend the time to file a petition for a writ of certiorari from December 19, 1988 to February 2, 1989, submitted to Justice Stevens.
2	Dec 12 1988		Application (A88-466) granted by Justice Stevens extending the time to file until February 8, 1989.
3	Feb 7 1989	G	Petition for writ of certiorari filed.
5	Mar 1 1989		Order extending time to file brief of respondent on the merits until April 1, 1989.
7	Mar 30 1989		Brief of respondent Indianapolis Power & Light in opposition filed.
6	Apr 1 1989		Brief amici curiae of American Information Technologies Corporation, et al. filed.
8	Apr 5 1989		DISTRIBUTED. April 21, 1989
9	Apr 17 1989	X	Reply brief of petitioner filed.
10	Apr 24 1989		Petition GRANTED.
			**********
11	May 9 1989	G	Motion of the Acting Solicitor General to dispense with printing the joint appendix filed.
12	May 22 1989		Motion of the Acting Solicitor General to dispense with printing the joint appendix GRANTED.
14	Jun 6 1989		Order extending time to file brief of petitioner on the merits until June 26, 1989.
15	Jun 26 1989		Brief of petitioner CIR filed.
18	Jul 15 1989	N	Motion of American Information Technologies Corporation, et al. for leave to participate in oral argument as amici curiae and for divided argument filed.
17	Jul 21 1989		Order extending time to file brief of respondent on the merits until August 18, 1989.
19	Aug 18 1989		Brief amicus curiae of Wisconsin Electric Power Company and Affiliates filed.
20	Aug 18 1989		Brief amici curiae of American Information Technologies Corporation, et al. filed.
21	Aug 18 1989		Brief amicus curiae of Oak Industries, Inc. filed.
22	Aug 18 1989		Brief amicus curiae of El Paso Electric Company filed.
23	Aug 18 1989		Brief of respondent Indianapolis Power & Light Company filed.
24	Aug 24 1989		CIRCULATED.
26	Aug 28 1989		SET FOR ARGUMENT TUESDAY, OCTOBER 31, 1989. (2ND CASE)
25	Sep 1 1989		Record filed.
		*	Certified copy of C. A. Proceedngs received.
27	Sep 1 1989		Record filed.
		*	Certified copy of original record and exhibits received.

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No. 88-1319-CFX

Entry	Date	Note	Proceedings and Orders
28	Sep 13 1989	G	Application (A89-213) to extend the time to file a reply brief from September 18, 1989 to September 22, 1989, submitted to Justice Stevens.
29	Sep 15 1989		Application (A89-213) granted by Justice Stevens extending the time to file until September 22, 1989.
30	Sep 22 1989	X	Reply brief of petitioner filed.
31	Oct 31 1989		ARGUED.

PETITION FOR WRIT OF CERTIORARI

(1) 88-1319

No.

Supreme Court, U.S.
FILED
FEB 7 1989
JOSEPH F. SPANIOL, JR.
CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1988

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

INDIANAPOLIS POWER AND LIGHT COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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59 pp

QUESTION PRESENTED

Whether customer deposits required by a public utility to insure the payment of future bills are income to the utility upon receipt.

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In the Supreme Court of the United States

OCTOBER TERM, 1988

No.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

INDIANAPOLIS POWER AND LIGHT COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Seventh Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra*, 1a-18a) is reported at 857 F.2d 1162. The opinion of the Tax Court (App., *infra*, 19a-39a) is reported at 88 T.C. 964.

JURISDICTION

The judgment of the court of appeals (App., *infra*, 40a) was entered on September 20, 1988. On December 12, 1988, Justice Stevens extended the time within which to petition for a writ of certiorari to and including February 8, 1989. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTORY PROVISIONS INVOLVED

Section 61(a) of the Internal Revenue Code (26 U.S.C.) provides in pertinent part:

> **General Definition**
>
> Except as otherwise provided in this subtitle, gross income means all income from whatever source derived * * *.

Section 451(a) of the Internal Revenue Code (26 U.S.C.) provides:

> **General rule**
>
> The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

STATEMENT

1. Respondent is an Indiana corporation engaged in the business of generating, distributing, and selling electricity and steam in the vicinity of Indianapolis, Indiana. It is a public utility, subject to regulation by the Public Service Commission of Indiana (PSCI). As part of its customary method of conducting business during the years in issue, 1974-1977, respondent required approximately five percent of its commercial and residential customers to pay a deposit as a precondition to receiving service. The customers required to pay deposits were chosen based upon their creditworthiness, and the stated purpose of the deposits was "to insure prompt payment" of the customers' future utility bills. App., *infra*, 2a.

The details of respondent's deposit program changed during the years at issue because of amendments made by

PSCI to its rules of service on March 10, 1976. Prior to that time, respondent determined on an ad hoc basis when it would require a customer deposit, based on a creditworthiness analysis made by its own employees. The amount of the required deposit ordinarily was twice the customer's estimated monthly bill. Respondent refunded these deposits prior to termination of service only if the customer specifically requested a review and demonstrated his creditworthiness. Upon termination of service, respondent refunded the deposits by means of a credit to the final bill or, if requested by the customer, by cash or check. In addition, respondent was required to pay interest at the rate of three percent per year on deposits held at least six months. This interest was payable upon return of the deposit, or annually upon demand in writing by the customer. App., *infra*, 2a-3a.

The PSCI amended its rules of service concerning utility customer deposits in 1976, largely in order to reduce arbitrariness in the system. Under the amended rules (see Ind. Admin. Code tit. 8, r. (8-1-2-4)-A42 (Burns Supp. 1978)), respondent was required to determine the creditworthiness of each residential applicant or existing residential customer according to objective criteria.[1] Deposits could be required of new customers only if they failed a creditworthiness test furnished by the PSCI, and required of existing customers only if they had a history of late payments. The amended rules also specified that interest would have to be paid at the rate of six percent, but only on deposits held for more than 12 months. App., *infra*, 3a.

The amended rules of service also defined when a customer had reached a point at which his credit record

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[1] Commercial customers continued to be evaluated for creditworthiness on a case-by-case basis (App., *infra*, 3a).

was such that retention of a deposit should no longer be necessary. In compliance with those rules, respondent refunded residential customers' deposits after timely payment for a period of either nine successive months or ten out of any twelve consecutive months (provided that the two delinquent months were not consecutive), or if the customer subsequently satisfied the credit test. These refunds generally were made by cash or check unless the customer requested that they be credited against his bill. When a customer requested termination of service, however, respondent usually applied the deposit as a credit to the customer's final bill. In the event of an involuntary termination of service, respondent used the deposit to cover any unpaid balance in the customer's account, and any surplus was returned to the customer. Generally, an involuntary termination of service occurred when 90 days had elapsed after a bill was sent with no payment for the charges included on that bill or a later one. During the years in issue, between 57.7% and 69% of the amounts refunded were in the form of credits against the customer's bill. App., *infra*, 3a, 23a-25a.

The customer deposits received by respondent were not segregated from its other assets in any manner; they were subject to its unfettered control and were used in the ordinary course of its business. Respondent, an accrual basis taxpayer, treated the deposits on its books as current liabilities, not as producing gross income. When the deposits were refunded or applied against a customer's bill, respondent made appropriate accounting adjustments. App., *infra*, 3a-4a.[2]

[2] If a refundable deposit was unclaimed, it escheated to the state after seven years. During the period in issue, $1,197,629 in deposits was refunded by cash, check, or credit, and less than $9,324 in deposits escheated to the State. App., *infra*, 24a-25a.

2. The Commissioner issued a notice of deficiency asserting that customer deposits should be treated as advance payments and reported as income upon receipt. See Rev. Rul. 72-519, 1972-2 C.B. 32. Accordingly, he determined that respondent was required to include in its income for 1975 the balance of customer deposits outstanding at the end of the year (less the amount of deposits on hand at the end of 1954), and to adjust its income for each succeeding year by the amount of the increase or decrease in deposits on hand at the end of the year.[3] Respondent filed a petition in the Tax Court seeking redetermination of the deficiency.

The Tax Court ruled in favor of respondent in a reviewed opinion (App., *infra*, 19a-39a). The court followed the approach that it had taken in *City Gas Co.* v. *Commissioner*, 74 T.C. 386 (1980), rev'd, 689 F.2d 943 (11th Cir. 1982), and explicitly rejected the approach that the Eleventh Circuit had articulated in holding in *City Gas* that deposits paid to insure the payment of future utility bills are income upon receipt if they are under the control of the utility.[4] The Tax Court concluded that, in deter-

[3] This adjustment followed Rev. Rul. 72-519, *supra*, which specifies that, when customer deposits are treated as advance payments, such an adjustment is one attributable to a change in method of accounting governed by the provisions of Section 481 of the Internal Revenue Code (26 U.S.C.). The amount of the adjustment in the notice of deficiency was later recomputed to reflect the parties' agreement as to the applicability of Treas. Reg. § 1.451-5 (26 C.F.R.), which provides that the inclusion in income of certain advance payments for inventoriable goods may be deferred for up to two years after receipt and specifies certain cost offsets. The parties then stipulated that respondent's returns should be adjusted by these recomputed amounts "should the [Tax] Court determine that the customer deposits received by [respondent] are advance payments" (Stip. para. 30).

[4] The Tax Court is a court of national jurisdiction and is not bound to follow a court of appeals decision that reversed the Tax Court in an

mining whether a deposit to secure the payment of future bills is income upon receipt, it is necessary "to examine all of the facts and circumstances surrounding a deposit to evaluate the rights retained by the depositor and the rights acquired by the holder of the deposit" (App., *infra*, 34a). Under this approach, the Tax Court found that the following factors tilted toward a finding that the deposits should not be treated as income: the deposits were not intended as "advance payments" because only five percent of the customers were required to make the deposits, and they were chosen on the basis of creditworthiness; the customer controlled the method of refund in that he could elect to use the deposits as an offset or to receive a check; respondent had no rights in the ultimate disposition of the funds unless the customer failed to pay; respondent treated the deposits on its books as the customer's property; and respondent paid interest when it refunded a deposit. *Id.* at 34a-36a. The court concluded that "the deposits were not advance payments of income but were temporarily held by the petitioner to secure payment of the bills and were not therefore includable in gross income" (*id.* at 36a).

3. The court of appeals affirmed (App., *infra*, 1a-18a). Though recognizing that, "in terms of the recipient's cash flow, deposits to secure income items and advance payments are essentially the same" (*id.* at 9a), the court criticized the Eleventh Circuit's approach in *City Gas* as "implicitly assum[ing] that a deposit to secure the payment of an income item is the same as the prepayment of that income item" (*ibid.*). Instead, the court agreed with the Tax Court that each case turns on its particular "facts and circumstances" (*id.* at 11a, 16a). The court of appeals viewed the specific inquiry, however, as one that should focus on the economic benefits that flow to the utility from the temporary use of the customer's funds – in order to determine whether that use is sufficiently valuable to the utility to justify taxation upon receipt of the deposit (*id.* at 11a-17a).

Applying this economic analysis, the court identified two principal reasons why a deposit is "valuable" to a utility: 1) the security against possible delinquency; and 2) the ability to obtain a "return" (for example, by investment) on its possession of the funds (App., *infra*, 13a-14a). The court dismissed the "security factor" as insignificant to the inquiry, noting that it was equally present in the case of security deposits made to insure against property damage, which undisputedly are not treated as advance payments (see *id.* at 11a n.9, 14a). With respect to the "return factor," the court posited what it described as an "extreme case" in which the utility was required to invest the deposits in a particular manner and to refund to its customers every penny of the interest earned (*id.* at 14a-16a). In that situation, the court stated that there would be no return benefit at all, and therefore the deposit should not be treated as income. Reference to this "extreme case" led the court to find "that deposits to secure the payment of an income item such as rent can be a distinct category from advance payments for tax purposes" (*id.* at 16a).

The court of appeals thus concluded that it should "retain the traditional approach of analyzing the facts and circumstances to determine whether the principal purpose

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earlier case. The Tax Court does follow court of appeals decisions in the circuit to which an appeal in the case at hand would lie. See *Commissioner* v. *Portland Cement Co.*, 450 U.S. 156, 164 (1981); *Golsen* v. *Commissioner*, 54 T.C. 742, 756-758 (1970), aff'd, 445 F. 2d 985 (10th Cir.), cert. denied, 404 U.S. 940 (1971). Thus, in a case appealable to the Eleventh Circuit with facts closely paralleling those in the instant case, the Tax Court held on the authority of *City Gas* that the customer deposits were taxable as income upon receipt. *Gas Light Co.* v. *Commissioner*, 55 T.C.M. (P-H) ¶ 86,118 (1986).

of a 'deposit' is to secure future performance or to serve as an advance payment of income" (App., *infra*, 16a-17a). Applying this test, the court held that the Tax Court's decision that the deposits in this case "served as security and were not prepayments of income is not clearly erroneous" (*id.* at 17a). The court explained that the primary factor supporting this conclusion was the payment of interest. It also noted that the customer (through his payment record) " 'controlled' the timing of the refund" (*ibid.* (quoting *id.* at 34a)) and that respondent did not regard the deposits as prepayments (*id.* at 17a-18a).

REASONS FOR GRANTING THE PETITION

The decision of the court of appeals creates a conflict in the circuits on an important and recurring issue of federal tax law, namely, the tax treatment of deposits required to insure the payment of future utility bills. This issue is one that is likely to arise for almost any utility that requires some or all of its customers to deposit funds to guarantee payment for future services. And, because of the enormous number of customers who are required to make deposits with public utilities, considerable sums of money turn upon resolution of this issue. Moreover, the decision below may have ramifications with regard to other advance payment situations outside the public utility context. Accordingly, review by this Court is warranted to provide a uniform rule of decision on this significant question.

1. It is well established that an advance payment of income is taxable in the year of receipt. See, *e.g.*, *Schlude* v. *Commissioner*, 372 U.S. 128 (1963); *American Automobile Ass'n* v. *United States*, 367 U.S. 687 (1961). On the other hand, a deposit paid to secure the recipient against damage to its property, refundable if no such

damage occurs, is not income when received. In Rev. Rul. 72-519, 1972-2 C.B. 32, the Commissioner sought to delineate the situations in which security deposits would be treated for tax purposes as advance payments of income. Relying on cases involving rental agreements, the Revenue Ruling concluded that, "when the purpose of the deposit is to guarantee the customer's payment of amounts owed to the creditor, such a deposit is treated as an advance payment, but when the purpose of the deposit is to secure a property interest of the taxpayer the deposit is regarded as a true security deposit" (*id.* at 33).

In *City Gas Co.* v. *Commissioner*, 689 F.2d 943 (1982), the Eleventh Circuit held that customer deposits not materially distinguishable from the ones in this case are to be treated as prepayments and taxed as income upon receipt. The Eleventh Circuit rejected the Tax Court's ad hoc "facts and circumstances" approach and essentially adopted the distinction set forth by the Commissioner in Rev. Rul. 72-519. The Eleventh Circuit phrased its test as follows (689 F.2d at 948): "whether, under all the circumstances, the primary purpose of the payments at issue was a prepayment of income items, or whether the primary purpose was to secure the performance of nonincome-producing covenants." Noting that it was clear that the deposits were not intended solely to secure performance of nonincome-producing covenants (*id.* at 946) and that the Tax Court had not applied the primary purpose test, the Eleventh Circuit reversed and remanded for further proceedings (*id.* at 950).[5] In the course of

[5] On remand, the Tax Court found that the primary purpose of the deposits was to secure the payment of future income and therefore that they must be treated as advance payments and taxed as income on receipt. *City Gas Co.* v. *Commissioner*, 53 T.C.M. (P-H) ¶ 84,044 (1984).

its opinion, the court also rejected the taxpayer's argument that the payment of interest demonstrated that the deposits should not be treated as prepayments. The court of appeals stated that, "while the payment of interest might have significance under some circumstances, we doubt the importance of interest payments in this case," and it concluded that "the Tax Court properly placed little emphasis on whether or not interest was paid in this case" (*id.* at 948 n.7).[6]

The decision of the court of appeals below squarely conflicts with *City Gas*. First, the legal principles enunciated by the two courts of appeals to govern the treatment of utility deposits are irreconcilable. The Tax Court explicitly recognized that its decision to adhere to the "facts and circumstances" approach and rule in favor of respondent required it to reject the Eleventh Circuit's *City Gas* test (App., *infra*, 33a-34a). Similarly, the court of appeals, in looking to whether the "facts and circumstances" showed that the payment was intended as "security," recognized that it was rejecting the *City Gas* test (see *id.* at 18a n.13). The Eleventh Circuit held that a deposit intended to secure the payment of a future income item, as opposed to securing the performance of nonincome-producing covenants, must be treated as a prepayment of income (689 F.2d at 946; see also App., *infra*, 9a), but the Seventh Circuit held that any deposit intended as security—whether for an income item or a nonincome item—should not be treated as income upon receipt. In addition, the court of appeals

[6] *City Gas* involved three utilities whose cases were consolidated for decision in the Tax Court. One of those utilities paid interest on its deposits, and the others did not. 74 T.C. at 389. Neither the Tax Court, which held that none of the deposits should be treated as income on receipt, nor the court of appeals, which found that all of the deposits should be so treated, regarded the payment of interest as a basis for distinguishing one utility from another.

below noted that its heavy reliance on the payment of interest (see, *e.g.*, App., *infra*, 17a n.12) is at odds with the Eleventh Circuit's analysis, since that court in *City Gas* had stated that the payment of interest is of little importance in this context (see 689 F.2d at 948 n.7). App., *infra*, 15a n.11.

Second, the holding below on the facts of this case cannot be reconciled with the Eleventh Circuit's decision in *City Gas*. The deposits here are not materially distinguishable from those at issue in *City Gas*, and the Seventh Circuit made no attempt to explain how its decision could be consistent with the treatment of the deposits in *City Gas* as income upon receipt. One of the utilities in *City Gas* paid interest when it refunded deposits, the deposits there were held for an indefinite length of time, and the utilities did not treat them as advance payments on their books. Since these are the factors relied upon by the court of appeals below in holding that respondent was not required to treat the deposits as income upon receipt (App., *infra*, 17a-18a), there can be little doubt that it would have reached the same conclusion on the facts of *City Gas*, in direct conflict with the Eleventh Circuit. See also *Gas Light Co.* v. *Commissioner*, 55 T.C.M. (P-H) ¶ 86,118 at 489-490 (1986) (Tax Court rejects similar proffered distinctions of *City Gas* in case appealable to Eleventh Circuit).

2. The decision of the court of appeals is erroneous. The Eleventh Circuit correctly held in *City Gas* that deposits to secure the payment of future bills act as advance payments of those bills and should be taxed accordingly. Indeed, the court of appeals acknowledged that, "in terms of the recipient's cash flow, deposits to secure income items and advance payments are essentially the same" (App., *infra*, 9a). The deposit is taken into the possession and control of the utility at the time it is received, and it serves as a payment of future customer bills. If the customer defaults in the future, the deposit is used

to cover the bill, and it is essentially the same as an advance payment. If the deposit is refunded, the refund may be made in the form of a credit against future bills; again, the deposit is essentially the same as an advance payment. Only if a refund is made in the form of a cash or check payment to the customer does the deposit appear even superficially to be different from an advance payment. But the economic reality of such a refund is that it is the same as a credit against the customer's bill; the only difference is that in the former case there is an additional bilateral exchange of checks between the parties in the amount of the deposit. That formalistic difference should not alter the treatment of the deposit as an advance payment.

The court of appeals viewed the deposits here as indistinguishable from deposits made to secure the performance of nonincome-producing covenants, such as a deposit paid by a renter to secure the owner against property damage to the premises. But there is a significant difference between these two kinds of deposits with respect to the general income-recognition principles of our tax system. As we have explained, a deposit to secure the future payment of funds that will be income is essentially the same as an advance payment of income. That is not true of a deposit to secure the owner against property damage because the deposit is never converted into income. If there is no property damage, the deposit is returned to the renter. If there is property damage, the deposited funds are used to repair the property, which also does not yield income to the owner. Thus, a deposit to secure the performance of nonincome-producing covenants simply lacks the characteristics that make it appropriate to treat a deposit to secure future bill payments as an advance payment.

The court of appeals premised its holding here primarily on the fact that respondent was obligated to pay some interest in some cases when it refunded the deposits. But that fact is not inconsistent with treating the deposit payments as income upon receipt. Unlike the "extreme case" (App., *infra*, 16a) posited by the court of appeals in which the mode of investment of the deposited funds was prescribed and *all* of the interest earned on them was required to be refunded to the customer—and thus the deposits were essentially held in escrow rather than within the complete control of the utility—it is apparent here that the interest obligation did not interfere with respondent's use of the deposited funds or prevent it from benefiting from that use. Indeed, respondent was required to pay interest only at an annual rate of either three percent or six percent, and no interest obligation attached at all unless the deposit had been held for some minimum period, either six or twelve months. Plainly, such an interest requirement does not mean that the deposited funds should be viewed as if they were entirely the customer's property until applied to a utility bill; the interest requirement simply reflects what is undisputed—namely, that the funds were required to be paid in advance as a security deposit to guarantee the payment of future bills. Accordingly, as both the Tax Court and the Eleventh Circuit concluded in *City Gas* (see 689 F.2d at 948 n.7), the existence of an obligation to pay interest is not a particularly important factor—and certainly not dispositive—in determining whether a deposit is income upon receipt; "interest may reflect compensation for the advance payment of income items" (*ibid.*).

Moreover, the approach of the court of appeals below unnecessarily introduces uncertainty into the treatment of customer utility deposits. The Commissioner's ruling and the Eleventh Circuit's decision resolve the question of the correct treatment of security deposits by means of a principled analysis capable of even-handed application. The "facts and circumstances" approach of the court below, by

contrast, is much too amorphous and imprecise to provide an acceptable level of predictability for tax planning (see, *e.g.*, App., *infra*, 17a n.12). Different courts attempting to apply the court of appeals' vague balancing test are virtually certain to reach different results in cases involving similarly situated taxpayers. Thus, it is appropriate for this Court to grant certiorari to restore an objective and administrable approach to the treatment of security deposits.

3. The decision below concerns an issue of considerable administrative importance. Although the court of appeals characterized its holding as "limited" (App., *infra*, 16a), because it suggests a case-by-case approach based upon examination of all the "facts and circumstances," in reality the decision sweeps quite broadly. In ruling for respondent, the court relied almost entirely on the obligation to pay interest on the deposits, but made no attempt to explain why the particulars of the interest paid in this case compelled this result—even though the rate for at least part of the period was plainly below the market rate and interest was not even paid on all deposits. Thus, the decision below appears to establish the rule that an obligation to pay *any* interest on a deposit, or anything more than a nominal amount of interest, is sufficient to negate the claim that a deposit to secure the payment of future bills is income upon receipt. Such a rule obviously would affect the taxation of many utilities, to the extent they require customer deposits and pay interest thereon. Moreover, the decision below could have ramifications outside the utility context because it calls into question the tax treatment even of forms of prepayment that generally have been recognized as income upon receipt, such as prepayment of rent, if some interest is required to be paid to reflect the fact that payment has been made in advance.

Because of the large number of utility customers, the issue presented in this case involves considerable revenue, even though each individual deposit is relatively small. One recent case decided on this issue in the Tax Court involved deficiencies in excess of $100 million. See *American Telephone & Telegraph Co.* v. *Commissioner*, Tax Ct. Mem. Dec. (P-H) ¶ 88,035 (Feb. 3, 1988). While the amount at stake in that case was unusually large, the IRS estimates that there are currently pending, either administratively or in the courts, more than 150 cases involving more than $300 million in potential tax liabilities in which the tax treatment of customer deposits is at issue. This Court should grant certiorari here to resolve this important conflict in the circuits on an issue of industry-wide significance.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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FEBRUARY 1989

APPENDIX A

IN THE
UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

No. 87-2438

INDIANAPOLIS POWER & LIGHT COMPANY, APPELLEE

v.

COMMISSIONER OF INTERNAL REVENUE, APPELLANT

APPEAL FROM A DECISION OF THE
UNITED STATES TAX COURT

Argued February 19, 1988—Decided September 20, 1988

Before: BAUER, *Chief Judge*, and FLAUM, and KANNE, *Circuit Judges*.

FLAUM, *Circuit Judge*. The Internal Revenue Service ("IRS") assessed deficiencies against Indianapolis Power & Light Company ("IPL") for the tax years 1974-77, arguing that deposits IPL required certain customers to make in order to receive electrical services were advance payments for tax purposes that should have been included in gross income in the year IPL received them. IPL contested the deficiencies. The Tax Court ruled that the sums were security deposits and that IPL therefore properly excluded them from gross income. We affirm.[1]

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[1] Amicus curiae briefs were filed by Commonwealth Edison Company and by American Telephone and Telegraph Company. AT&T's

I.

IPL generates and sells electricity in Indianapolis and neighboring areas of Indiana. It is an Indiana public utility and is therefore subject to the Rules and Regulations of Service for Electrical Utilities in Indiana ("the Rules of Service") promulgated by the Public Service Commission of Indiana ("PSCI"). During the years in question, approximately 5% of IPL's customers were required under the Rules of Service to make deposits. The receipts issued to these customers stated in part that the deposits were "to insure prompt payment" for the electrical service IPL was to provide.[2] The customers to whom this requirement applied were identified by a credit test. If a customer who was initially required to make a deposit later demonstrated creditworthiness, the deposit was refunded.

The specific rules governing the administration of this deposit program were amended on March 10, 1976. Prior to this amendment, IPL administered the deposit requirement on a case-by-case basis. A credit test was employed, but there were no fixed financial rules for making the creditworthiness determination. Once a customer was required to make a deposit, the customer could only obtain a refund by specifically requesting a review and then affirmatively demonstrating his or her creditworthiness. The amount of the deposit was equal to twice the customer's estimated monthly bill and IPL paid interest at an annual rate of 3% on sums held at least six months. The interest

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brief was filed jointly with a group of divested Bell Telephone subsidiaries collectively referred to as "the Regional Holding Companies."

[2] The charge for electrical service was usually the largest item on a customer's utility bill, but charges for disconnection, reconnection, late payments, returned checks, and meter tampering were also possible.

was paid at the time the deposit was refunded or alternatively, if the customer requested, annually. The manner of the refund, either by cash, check, or an offset against the customer's electric bill, was determined by the customer.

The 1976 amendments were largely designed to minimize the arbitrariness that was perceived to exist under the prior rules. Under the revised rules, IPL was required to evaluate the creditworthiness of all new residential applicants and existing residential customers. IPL required deposits from those new customers who failed the credit test furnished by PSCI and also from existing customers who had a history of late payment. Commercial customers continued to be evaluated on a case-by-case basis.

Under the amended rules, IPL refunded a customer's deposit if the customer paid his or her electric bill on a timely basis for nine straight months or for ten out of twelve months (as long as the two delinquent months were not consecutive). Alternatively, the customer could obtain a refund by later satisfying the credit test. Deposits refunded on either of these two grounds were made in cash or by check, unless the customer requested that the amount of the deposit be offset against his or her bill. On the other hand, refunds resulting from the termination of service were generally made by offsetting the deposit amount against the customer's final electric bill, unless the customer specifically requested otherwise. Customers whose deposits were held by IPL for at least 12 months were paid interest at 6% annually. Information about the deposit requirement and corresponding refunds was set forth in a pamphlet which IPL was required to provide to its customers.

The customer deposits IPL received were not segregated from its other assets in any manner, but rather IPL used

them in the ordinary course of its business. IPL was an accrual basis taxpayer for the years in question and treated the deposits as current liabilities at the time they were received.[3] If the deposit was later used to offset a customer's bill, IPL made the necessary accounting adjustments at that time. Unclaimed deposits escheated to the state.

II.

A.

The issues raised by this appeals is whether IPL should have included the customer deposits in gross income in the year of receipt (with a corresponding loss when refunded) rather than recording them as a current liability.[4] This in turn hinges on the legal standard a court should utilize when evaluating the taxability of customer deposits. The IRS argues that the proper test for determining the tax consequences of these types of deposits is set forth in *City*

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[3] The Rules of Service required IPL to treat these deposits as current liabilities for regulatory accounting purposes. Ind. Admin. Rules and Regs. Tit. 8, r. (8-1-2-10) C11 (Burns Supp. 1978).

[4] The consequence of the IRS's assessment to IPL is technically one of timing, but in practical terms may result in a one-time tax on IPL's customer deposit base. Under the IRS's position, IPL would be required to include its entire deposit base in gross income in 1974, and then any incremental increase or decrease would represent additional income or loss in each of its following tax years. If the deposit base increased, the amount of this additional increase would be included in gross income. If the total dollar value of refunds exceeded the amount of additional deposits, IPL would report a loss for tax purposes. Because the amount of IPL's deposit base grew in 1975, 1976, and 1977, the IRS assessed deficiencies for these years. Assuming that IPL's deposit base does not shrink in the near future, the loss corresponding to a refund will be of a substantially lower value in terms of dollars adjusted for the time value of money.

Gas Co. of Florida v. *Commissioner*, 689 F.2d 943 (11th Cir. 1982).

The facts in *City Gas* are very similar to those in the present case. New customers of the City Gas Company and two of its subsidiaries were required to make deposits to secure the payment of all bills for service rendered to them. All three of the companies mingled the deposits they received with their other corporate funds. City Gas, but not its two subsidiaries, paid interest to its customers on their deposits at 4% annually. When a customer discontinued service the companies refunded the deposit by either crediting the amount against the customer's final bill or by sending the customer a check.

The Tax Court in *City Gas* ruled that these customer deposits were not taxable when received by the three companies. The Eleventh Circuit reversed, ruling that the proper test is to look at the primary purpose of the deposit. If its primary purpose is to secure the future payment for goods or services to be provided by the deposit recipient, then it is taxable upon receipt in the same manner as an advance payment of income. *City Gas*, 689 F.2d at 946, 948 n.7. On the other hand, if the deposit is designed to cover any damage to property in the possession of the depositor, but owned by the deposit recipient, or to secure the performance of other non-income provisions of a contract ("non-income covenants"), it is not considered an advance payment. *Id.* Because it is undisputed that the purpose of the deposits received by IPL was to secure the payment of their customer's electric bill, an income item, the IRS asserts that IPL should have included the deposits in gross income when it received them.

A unanimous Tax Court declined to apply the Eleventh Circuit's *City Gas* test in this case. *Indianapolis Power & Light Co.* v. *Commissioner*, 88 T.C. 964 (1987). Rather, the Tax Court adhered to its own prior decision in *City*

Gas and held that the proper approach is to determine whether in the facts and circumstances of the case, the customer deposit serves as an advance payment of income or as security for future performance.[3] In the Tax Court's view, this determination is made by comparing the rights retained by the depositor with the rights acquired by the depositee. If the deposit is to serve as security, it is properly excluded from income, regardless of whether the future performance it secures is the paymentof income for services to customers or merely non-income covenants such as protecting against damage to property.

Employing this test, the Tax Court ruled that the customer deposits held by IPL were properly excluded from IPL's gross income. The Tax Court primarily relied on three factors. First, only five percent of the customers were required to make deposits. The Tax Court reasoned that if the deposits were really intended to serve as an advance payment, IPL would have required such deposits from all of its customers. Second, although IPL had discretion as to how to use the deposits it held, the customers controlled the timing and the disposition of the deposit. Prior to 1976 a customer could request a reevaluation of his or her creditworthiness and after 1976 a customer's timely payment of his or her bill for nine consecutive months led to an automatic refund. IPL paid between 30% and 40% of its refunds by check; it handled the remainder by offsetting the deposit amount against the customer's bill. Third, IPL paid interest on the deposits.

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[3] The Tax Court also declined to follow the Eleventh Circuit's *City Gas* test in *American Telephone and Telegraph Co.* v. *Commissioner*, 55 T.C.M. 16 (1988). The Tax Court did apply the *City Gas* test in *Gas Light Co. of Columbus* v. *Commissioner*, 51 T.C.M. 685 (1986), but that case was appealable to the Eleventh Circuit.

The proper legal test for a court to apply in determining the appropriate tax treatment of deposits such as those received by IPL is a question of law which we review de novo. IPL's intentions and purposes in requiring customers to make these deposits, however, are questions of fact which we review under a clearly erroneous standard. *Busch* v. *Commissioner*, 728 F.2d 945 (7th Cir. 1984).

B.

We begin with the two baseline rules with which both parties agree. First, a deposit given to secure a nonincome covenant is non-taxable to the deposit recipient. Gross income is defined to include all income from whatever source. 26 U.S.C. § 61. A deposit to secure tangible property, however, is not considered income because it is offset by an obligation to refund the deposit if the property being used by the depositor is returned to the deposit recipient undamaged. Frequently the deposit recipient has unrestricted use of the deposit during this time period. Despite this discretion, the deposit recipient is not required to include the deposit in gross income because he or she is not considered to have "gained" for tax purposes. *Clinton Hotel Realty Corp.* v. *Commissioner*, 128 F.2d 968, 969 (5th Cir. 1942); *J. & E. Enterprises, Inc.* v. *Commissioner*, 26 T.C.M. 944, 946 (1967). *See also Illinois Power Co.* v. *Commissioner*, 792 F.2d 683, 689 (7th Cir. 1986) ("taxpayer is allowed to exclude from his income money received under an unequivocal contractual, statutory, or regulatory duty to repay it, so that he is really just the custodian of the money."). In this respect, the deposit recipient's situation is analogous to the typical cash loan. The borrower does not include the loan proceeds in gross income because he or she also incurs an obligation to repay the money. *Commissioner* v. *Tufts*, 461 U.S. 300, 319 (1983).

The second proposition with which both parties agree is that "advance payments" must generally be included in gross income by the recipient when received, even if the recipient uses an accrual basis of accounting for tax purposes. Perhaps the best example of an advance payment is a lease that requires the lessee to pay a sum equal to one period's rent at the start of the lease term which is to be applied to the payment of the last period's rent. In this situation, the amount of the advance is taxable income to the lessor at the time of receipt, rather than when it is "earned" for accrual accounting purpose in the last term of the lease. *See, e.g., Astor Holding Co.* v. *Commissioner*, 135 F.2d 47 (5th Cir. 1943) (partial payment of tenth year's rent up from was prepayment of rent and taxable to the lessor upon receipt). The traditional justification for this result is that from the moment of receipt the lessor can "use the advance payment as its own money." *Id.* at 48. Courts have characterized sums paid at the outset of a contract as advance payments even when the recipient is contractually obligated to return the money if some remote contingency occurs. *See, e.g, Van Wagoner* v. *United States*, 368 F.2d 95 (5th Cir. 1966) ("deposit premium" received by insurance agent taxable upon receipt even though agent required to return the amount if the policy was cancelled); *Hirsh Improvement Co.* v. *Commissioner*, 143 F.2d 912 (2nd Cir.), *cert. denied*, 323 U.S. 750 (1944) (lessor required to return an amount to be applied to the last year's rent if the leased premises destroyed prior to the expiration of the lease). This result is justified on the grounds that the possibility that the lessor would have to repay the sum is too unlikely to prevent the sum from being characterized as an advance payment of rent. *See, e.g., Hirsh*, 149 F.2d at 915. *See also Illinois Power*, 792 F.2d at 690 ("usually the court just asks

how likely is repayment, and if the answer is, not very, the receipt is treated as income").

After carefully reviewing the prior case law, the Eleventh Circuit concluded in *City Gas* that the proper test for distinguishing security deposits from advance payments "is whether, under all the circumstances, the primary purpose of the payments at issue was a prepayment of income items, or whether the primary purpose was to secure the performance of nonincome-producing covenants." 689 F.2d at 948 (footnote omitted). In stating the test in this manner, the Eleventh Circuit implicitly assumed that a deposit to secure the payment of an income item is the same as the prepayment of that income item.[6] Under this test, a sum given primarily to secure the performance of an income producing covenant is taxed as an advance payment. Underlying this view is the recognition that in terms of the recipient's cash flow, deposits to secure income items and advance payments are essentially the same.

This point is demonstrated by comparing a prepayment of rent with a deposit to secure the payment of rent. In each instance, assuming the lessee does not default, the lessor receives the sum up front and has discretion over the use of the money during the lease term. The fundamental distinction between these two cases is that in the deposit situation the lessor has a legal obligation to return the amount of the deposit when the lesses makes the final rent

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[6] On remand, for example, the Tax Court observed that under the *City Gas* test "deposits must be categorized either as prepayments for goods and services on the one hand, or as security for the performance of non-income-producing covenants on the other. The Eleventh Circuit, as we understand it, did not admit to the possibility of other categories." *City Gas Co. of Florida* v. *Commissioner*, 47 T.C.M. 971, 973 (1984) (footnote omitted).

payment. In practical terms, however, this is just an exchange of checks. The lessee pays the last month's rent and the lessor returns the deposit; these payments offset each other. In each case, the lessor receives his or her rent on a timely basis and has "the use" of the deposit amount from the start of the lease until the final rent payment is made. The situations are also similar if the lessee defaults. A lessor who receives either an advance payment or a rent deposit is entitled to the remaining rent payments under the lease and uses the deposit advance to satisfy one of these remaining payments.[7]

The functional similarity between an advance payment of rent and a deposit to secure the payment of rent suggests that they should be taxed similarly. The crux of this position is that the importance of the unconditional obligation to return the deposit amount should not control for tax purposes because the deposit recipient had the use of the deposit amount for the same time period as if the sum received was undisputably an advance payment of rent; the return of the deposit amount is of no consequence because it is offset by the final month's rent payment. In its simplest terms, the IRS's argument is that deposits to secure rent must be taxed the same as advance payments because otherwise lessors desiring the non-tax advantages associated with advance payments could obtain them and at the same time avoid the resulting adverse tax consequences by structuring the deal as a deposit. In the IRS's view, this result cannot be justified because from the perspective of the parties there is no functional difference between the two arrangements. Accordingly, the

[7] We note that the lessee would presumably have the same status for bankruptcy purposes should the lessor go bankrupt regardless of whether a payment was classified as an advance payment, a deposit to secure income, or a deposit to secure property.

IRS advocates that we adopt the Eleventh Circuit's primary purpose test.[8]

Although we believe that the proper approach to determining the appropriate tax treatment of a customer deposit is to look at the primary purpose of the deposit based on all the facts and circumstances, we conclude that the application of this test does not require a finding that a deposit to secure an income payment must always be taxed as an advance payment.[9] In order to explain our position,

[8] The IRS also quotes Justice Brandeis' famous statement setting forth "The Claim of Right Doctrine":

> If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.

North American Oil Consol. v. *Burnet*, 286 U.S. 417, 424 (1932). As we stated in *Illinois Power*, "whether the money is received 'under a claim right'—is often a conclusion rather than a criterion; it is so in this case." 792 F.2d at 688.

[9] We note that by overlooking the lessor's legal obligations and focusing on "the economic substance of the transaction," Appellant's Br. at 19, the IRS fails in our view to persuasively explain why deposits to secure income should be treated differently from deposits to secure property that are given in conjunction with a contractual arrangement that generates an income stream (which the IRS concedes should not be included in a taxpayer's gross income upon receipt). A lessor who requires a deposit to secure against damage to leased property also has use of the deposit amount during the lease term. If no damage occurs, the money is returned to the lessee. Assuming rent is paid at the end of the month, the exchange of checks will probably be no less contemporaneous than it is with a deposit to secure the payment of rent (if the rent is paid at the beginning of the month the lessor actually has the use of the lessee's deposit money for one more month than if it secured only the rent payment). If the property is damaged by the lessee, the deposit is applied to the cost of repairs.

In either case, however, the lessor holds the sum, usually with total discretion as to its use, during the period the property is in the lessee's possession. In terms of cash flow to the lessor, a deposit to secure property is at least as advantageous as a deposit to secure the payment of rent.

The IRS asserts that the two situations are distinguishable because a deposit to secure property "generally will not give rise to income, even if ultimately retained by the taxpayer." *Id.* at 18 n.10. The IRS reasons that any property damage incurred by the deposit recipient, if deductible as a loss, would be offset by the application of the deposit. *Id.* (We suspect that the deposit recipient's gain or loss would be determined by comparing the amount of the deposit applied to repair or replace the damaged property with the deposit recipient's basis in the property). In contrast, the IRS argues, the use of a deposit to secure rent to satisfy a missed rent payment is accompanied by the recognition of rent revenue. But for an accrual basis taxpayer, the rent revenue arises from the lessee's use of the leased property and is recognized independently of whether there is a deposit to secure its payment or not. If there is no such deposit, the taxpayer still recognizes rent revenue but debits "rent receivable" instead of "deposit to secure rent."

The IRS's argument, relying on revenue recognition principles, seems inconsistent with its position on the appropriate tax treatment of deposits to secure income which does not respect the taxpayer's accrual accounting system. The IRS argues that a deposit to secure income should be taxed upon receipt rather than when the rent revenue accrues. The lessor, however, typically has no rights in this type of deposit until the lessee defaults. In essence the IRS justifies taxing an income deposit upon receipt because the sum is available at the outset and the parties contemplate that it can be used to satisfy the lessee's obligations that will accrue under the lease. But when a lessor holds a deposit to secure property and the lessee defaults on a rent payment, although the lessor may not be able to apply the deposit to directly cover the rent as would be the case with a deposit to secure the payment of rent, in practical terms the lessor will retain the deposit and apply it to satisfy a judgment relating to the lessee's nonpayment under the lease. The lessor therefore never divests the deposit amount in either case. Thus, once one focuses on "economic substance," the distinction between a deposit to secure income and a deposit to secure property is not so clear and it is less apparent why a deposit to secure income should be taxed as an advance payment rather than as a deposit to secure property.

we re-examine the rationale for the tax-treatment of advance payments. As previously noted, the traditional explanation for requiring recipients to include advance payments in income upon receipt is that the recipient can "use the advance payment as its own." *Astor Holding Co.*, 135 F.2d at 48. In this case IPL had discretion over the disposition of its customers' deposits, but was legally required to "refund" the deposit if a customer established creditworthiness and was also required to pay interest in the interim. The critical issue therefore is what does "the use" of the proceeds mean and in what circumstances is it taxed.

There are two principal reasons why having the use of a sum of money, either as a deposit or an advance payment, is valuable to the recipient. First, until the sum is returned to the depositor, or in the case of an advance payment, until it is formally applied to satisfy the obligation that will accrue, it can be used by the recipient to generate a return ("the return factor"). In the simplest case, this would be the interest the recipient could earn by putting the sum in a savings account. Second, if the money is received upfront, the recipient is saved at least a portion of the costs that arise if the other party to the contract should later default ("the security factor"). In the case of a deposit to secure the payment of rent, if the lessee fails to make a rent payment the lessor is able to apply the deposit to satisfy the missed payment and is perhaps spared the legal expense and other costs associated with collecting from the defaulting lessee.[10] In practical terms, an advance pay-

[10] This may be true even where the lessee breaches very early in the lease term. In *Clinton Hotel,* 128 F.2d 968, for example, the lessor received a sum equal to one year's rent on a ten year lease at the outset. A payment such as this affords the lessor time in which to possibly rerent the property to another party for the remainder of the lease term and thereby mitigate his or her exposure to the lessee's default.

ment of rent operates in the same way. This is also true with deposits given to secure the deposit recipient's property. The deposit recipient can use the deposit to offset the cost of repairing any damage to the property and thereby avoid the difficulty of locating and collecting from the breaching party.

If, however, the deposit recipient pays interest to the depositor, at least a portion of the return factor's value is lost because the return that is generated is offset by the interest paid. The deposit recipient may still benefit from possessing the deposit if the return he or she is able to make from the deposit exceeds the interest rate paid to the depositor, but this is also true of the typical loan and does not make the loan proceeds taxable to the borrower upon receipt. Accordingly, when a reasonable rate of interest is paid on a deposit, the value of the deposit to the depositee may relate predominantly to the "security factor," which comports more squarely with the common sense definition of a security deposit.

Assume for example that IPL was required by an agreement with its depositors to keep the deposits in its general corporate savings account (although commingled with IPL's other savings) and to pay the depositors the same rate of interest that it received from the bank. In this situation presumably the only benefit IPL receives from holding the deposits is the security afforded in case a customer fails to pay its bill; the return factor has been negated. Although the recipient is assured that a customer's outstanding bill will be paid, this benefit alone in our view does not constitute "the use" of the proceeds in a manner sufficient to justify immediate taxation of the deposit. The deposit merely assures that IPL will be paid and minimizes the collection costs IPL would otherwise incur if the depositor defaults, functions typically associated with security deposits. In contrast, in common parlance an

advance payment means "getting the money upfront." The recipient is required to include the sum in income when he or she receives the payment because typically the entire return generated during the interim will accrue to the recipient without an offsetting interest payment.[11]

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[11] We recognize that perhaps no court has focused this specifically on interest and that in each case the reviewing court has considered other factors, but the presence or absence of the payment of interest substantially reconciles the line of cases addressing the taxability of customer deposits. *See Van Wagoner,* 368 F.2d 95 (deposit premium received by insurance agent taxable upon receipt because agent had total discretion as to use and no interest paid); *Gilken Corp. v. Commissioner,* 176 F.2d 141 (6th Cir. 1949) (sum received to secure lease covenants and as part of purchase price if option to buy exercised was taxable in the year of receipt—no interest was paid by the lessor); *Hirsch Improvement,* 143 F.2d 912 (sum paid at beginning of lease taxable income upon receipt where the sum was distributed to the shareholders and interest was not paid to the depositor); *Astor Holding Co.*, 135 F.2d 47 (sum paid at the beginning of the lease where recipient used the sum as its own and paid no interest to the depositor); *Clinton Hotel,* 128 F.2d 968 (sum paid at outset of lease not taxable were interest paid to the depositor and the deposit might be applied to many things besides the last year's rent); *American Telephone,* 55 T.C.M. 16 (deposits to secure payment of telephone bills upon which interest were paid were not taxable in the year of receipt); *Oak Industries, Inc.* v. *Commissioner,* 52 T.C.M. 1556 (1987) (sums received by subscription television company when customers obtained electronic decoder boxes were taxable income upon receipt—no interest was paid by the company); *J & E Enterprises,* 26 T.C.M. 944 (payment of sum at outset of lease was taxable income when received where there was no restrictions on its use and interest was not paid). *Cf. Mantell v. Commissioner,* 17 T.C. 1143 (1952) (sum received at outset of lease was not taxable income when received even though no interest was paid to the lessee with respect to the sum). *See generally* Revenue Ruling 72-519, 1972-2 C.B. 82.

In *City Gas*, the Eleventh Circuit specifically down-played the importance of interest payments of the type IPL made stating that it "may reflect compensation for advance payment of income items. . . ." 689 F.2d at 948 n.7. The Eleventh Circuit cited *United States* v.

We recognize that we have postulated an extreme case, but the point is that as the interest rate paid on a deposit to secure income begins to approximate the return that the recipient would be expected to make from "the use" of the deposit amount, the deposit begins to serve purposes that comport more squarely with a security deposit. We therefore hold that deposits to secure the payment of an income item such as rent can be a distinct category from advance payments for tax purposes.

We emphasize the limited scope of our holding. The difficulty in these types of cases arises because the deposit to secure an income payment is given in conjunction with a contractual arrangement that also generates an income stream to the deposit recipient. The temptation, as the IRS's position demonstrates, is to always collapse the two. We hold only that this result is not automatically required. We therefore retain the traditional approach of analyzing the facts and circumstances to determine whether the principal purpose of a "deposit" is to secure future performance or to serve as an advance payment of income.[12]

Williams, 395 F.2d 508 (5th Cir. 1968) in support of this proposition. In *Williams* the taxpayer entered into an agreement granting a third-party the right to cut and purchase timber. Under the agreement the taxpayer received a sum, labelled a loan, that corresponded to the first ten years' rent. The taxpayer was to pay interest at 3% but the interest payment was offset by the annual rent owed by the third-party to the taxpayer. The Fifth Circuit reversed the district court's judgment in favor of the taxpayer, holding that the sum constituted an advance payment, not a loan. The Fifth Circuit observed that no due date was specified for the loan and that no promissory note was ever executed. The court also stated that it viewed "the interest charge as no more than compensation for [the] advance payment." *Id.* at 511. In essence, however, the Fifth Circuit merely collapsed the interest payment with the annual rent because it found that a bona fide loan was not created. In contrast, the enforceability of IPL's deposit obligations is not contested, only the legal consequences arising from them are at issue. *See also Commissioner* v. *Lyons*, 97 F.2d 70 (9th Cir. 1938).

C.

Applying this test to the deposits received by IPL, we hold that the Tax Court's decision that these deposits served as security and were not prepayments of income is not clearly erroneous. Depositors received interest at 3% prior to 1976 and 6% after 1976. The Tax Court found this to be of "particular importance." *Indianapolis Power & Light Co.* v. *Commissioner*, 88 T.C. at 976. In addition, the Tax Court placed special emphasis on the fact that the customer "controlled" the timing of the refund. After 1976, for example, the deposit was automatically refunded if a customer paid his or her utility bill punctually for nine straight months. The IRS argues that the depositor always "controls" the deposit by merely complying with the contract terms for its refund, and further that in functional terms the deposit acts as a mere prepayment of the ninth month's bill. We agree with the Tax Court that the indefiniteness of the length of time a customer deposits will be held is more consistent with a security deposit than a prepayment. Finally, the Tax Court found that IPL never

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[12] As our prior discussion indicates, the payment or nonpayment of interest on a deposit is in our view a very important factor in analyzing the "facts and circumstances." We expect, however, that in a significant percentage of the cases involving these types of deposits, the differential between the interest rate paid and the probable return (which will usually be difficult to determine) generated by the deposit recipient's use of the deposit will be such that a reviewing court will also have to consider other factors to determine the "primary purpose" of the customer deposit.

intended to have the deposits serve as prepayments. The Tax Court's decision is AFFIRMED.[13]

[13] We also reject the IRS's argument that we should adopt the *City Gas* test because it is more administratively convenient. The *City Gas* test also requires a court to look at all the facts and circumstances to discern the primary purpose of the deposit and therefore does not substantially simplify the review required.

APPENDIX B

UNITED STATES TAX COURT

Docket No. 925-82
88 T. C. No. 52

INDIANAPOLIS POWER AND LIGHT COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Filed April 20, 1987

SIMPSON, *Judge:* The Commissioner determined the following deficiencies in the petitioner's Federal income taxes: $134,073 for 1974, $553,254 for 1975, $174,668 for 1976, and $18,446 for 1977. After concessions by the parties, the only issue for decision is whether, in the circumstances of this case, customer deposits received by a public utility are includable in income upon receipt as advance payments.

FINDINGS OF FACT

To the credit of both parties, many of the facts have been stipulated, and those facts are so found.

The petitioner, Indianapolis Power and Light Company, maintained its principal offices in Indianapolis, Indiana, at the time its petition in this case was filed. The petitioner filed its Federal income tax returns for the years 1974, 1975, 1976, and 1977 with the District Director of Internal Revenue, Indianapolis, Indiana.

The petitioner is an operating public utility which was incorporated under the laws of the State of Indiana on October 27, 1926. Since the date of its incorporation, the petitioner has been primarily engaged in generating, transmitting, distributing, and selling electrical energy in Indianapolis and in neighboring areas within the State of Indiana. It also produces, distributes, and sells steam within a limited area of Indianapolis.

As an Indiana public utility, the petitioner has always been subject to regulation by the Public Service Commission of Indiana (PSCI), which has promulgated Rules and Regulations of Service for Electrical Utilities in Indiana (the rules of service). The rules of service include, among other things, a rule concerning customer deposits collected by electrical utilities in Indiana. Ind. Admin. Rules and Regs. tit. 8, r. (8-1-2-4)-A42 (Burns Supp. 1978). Such rule was amended by the PSCI on March 10, 1976. The amendments primarily affected the policies for deposits collected from residential customers and not the policies for deposits from commercial customers.

As part of its customary method of conducting business during the years in issue, the petitioner required deposits from certain of its commercial and residential customers. Such deposits were intended to insure the payment of such customers' utility bills. The charge for electrical service was usually the largest item on a customer's utility bill; however, such a bill could also contain charges for disconnection, for reconnection, for late payments, for returned checks, and for meter tampering. Approximately 95 percent of the petitioner's customers never had to make such a deposit. Commercial customers often made different arrangements, including the submission of letters of credit or the pledge of assets.

While the collection of customer deposits from the petitioner's residential customers was not normally a condition for obtaining or continuing service, a deposit would occasionally be a condition for providing service to a nonresidential customer. For example, if the customer requesting service was a transient merchant who was previously a delinquent customer, the petitioner might require a security deposit prior to connection of service. The fact that the petitioner received a customer's deposit did not create an obligation on the part of the petitioner to provide service to the customer.

Under the rules of service during the years at issue, the petitioner was required to issue a receipt to every customer who was required to make a security deposit. Such receipt stated that the deposit was to "insure prompt payment for electric service, steam service, or both" and that such deposit would be refunded "after Service has been disconnected and all bills due have been paid."

Prior to the amendments of the rules of service, the petitioner made the determination that a customer deposit was required on a case-by-case basis. The determination was based on a c[illegible]ditworthiness analysis made by the petitioner, but no fixed or prescribed formula was followed in making such determination. The amount of such deposit was ordinarily twice the customer's estimated monthly bill, and the petitioner was required to pay interest at the rate of 3 percent per year on every deposit held at least 6 months. Accumulated interest was payable upon return of the deposit or annually upon demand in writing by the customer.[1]

Prior to the amendments of the rules of service, the petitioner refunded customer deposits prior to termination of service if the customer requested a refund and met the

[1] The phrase "customer deposit" will be used to include the initial deposit and any accumulated, and unpaid, interest.

petitioner's creditworthiness standards. Such a refund was usually made in cash or by check, but was sometimes made by a credit to the customer's utility bill. The manner in which such a refund was made was usually determined by the customer; the petitioner asked the customer how he wanted the security deposit refunded. Upon termination of service, the petitioner refunded customer deposits by cash or check, if the customer requested it and paid his final bill. The petitioner refunded customer deposits by a credit to the customer's final bill when requested to do so by the customer, or when the customer had no preference as to the manner of refund and there was an unpaid balance in the customer's account; any surplus was returned to the customer by cash or check.

After the amendments of the rules of service, the petitioner was required to determine the creditworthiness of each residential applicant or existing residential customer, and customer deposits could be required only of those new customers who failed the creditworthiness test supplied by PSCI or those existing customers who had a history of late payments. The amount of such deposits could not exceed one-sixth of the annual billings of the customer, and deposits held more than 12 months earned interest at the rate of 6 percent per year. If a deposit was greater than $70, a residential customer was entitled to pay such deposit in equal installments over a period of no less than 8 weeks, with service starting upon receipt of the first installment. Commercial customers continued to be evaluated for creditworthiness on a case-by-case basis.

The amended rules of service required the petitioner to refund any residential customer deposit "upon satisfactory payment by the customer for a period of either nine successive months or ten out of any twelve consecutive months (provided that the customer did not make late

payments for any two consecutive months), or upon the customer demonstrating his creditworthiness by any other means." After the amendments of the rules of service, the petitioner automatically refunded residential customer deposits prior to termination of service if the customer satisfied the new creditworthiness criteria. Such a refund was made in cash or by check, or it was made as a credit to the customer's bill, if the customer specifically asked for that treatment. Customers were informed of their rights regarding such refunds in a pamphlet the petitioner was required to provide to all of its customers.

When a customer requested termination of service after the amendments of the rules of service, the petitioner usually applied the deposit as a credit to the customer's final bill. However, upon specific request from the customer, the petitioner had to refund directly the deposit within 15 days after payment of the final bill by the customer. In the event of an involuntary termination of service, the customer deposit was used by the petitioner to cover any unpaid balance of the customer's account, and any surplus was returned to the customer. In general, an involuntary termination of service occured about 90 days after a customer bill was sent and no payment had been received from the customer for charges included on such bill or a subsequent bill.

For each of the years in issue, the petitioner reported its income by use of the accrual method of accounting, and for financial, regulatory, and tax-reporting purposes, the petitioner always treated the customer deposits as current liabilities and not as gross income. Customer deposits were not physically segregated from the petitioner's general funds and were subject to the petitioner's unfettered use and control. However, the petitioner always recognized the customer's right to a refund of his deposit until and

unless the customer failed to pay his bill and service was disconnected; it never intended the customer deposits to represent advance payments for electric or steam service.

The rules of service required the petitioner to treat customer deposits as current liabilities in maintaining its books and records and preparing its reports for regulatory accounting purposes. Ind. Admin. Rules and Regs. tit. 8, r. (8-1-2-10)-C11 (Burns Supp. 1978). Such treatment of customer deposits was in accordance with generally accepted accounting principles and clearly reflects income for financial accounting purposes. Consequently, the petitioner's method of accounting for customer deposits has been accepted and never questioned by its independent accountants.

Under State law, unclaimed customer deposits escheated to the State of Indiana after 7 years. Ind. Code Ann. sec. 32-9-1-6 (Burns Supp. 1986). The total amount of customer deposits that escheated to the State from 1974 through 1977 was not more than $9,323.79.

The balance in the petitioner's customer deposit account was $546,793.00 on December 31, 1954,[2] $999,264.40 on December 31, 1974, $1,078,460.52 on December 31, 1975, $908,972.05 on December 31, 1976, and $883,027.54 on December 31, 1977. Some refunds were made in cash; those were offset against cash collections, and no records were kept of them. In the case of other refunds, some were

[2] The parties stipulated that such amount was the balance on Dec. 31, 1954, and it was represented as such by both parties in their briefs. However, such amount was listed as "Pre-1954 customer deposits" in the notice of deficiency. In the petition and amended petition, it was also assumed to be the balance on Dec. 31, 1953, and it was used as such to calculate the additions to income arising from customer deposits. Resolution of any inconsistency is not required because both parties agree that $546,793.00 is the base from which customer deposit income adjustments were calculated.

refunded wholly by check, some wholly by crediting them against bills, and others by check in part and credit in part. The following table sets forth the amounts of total refunds for each year and the percentage refunded wholly by check, partially by check, and by credit:

	1974	*1975*	*1976*	*1977*
Total Dollar Amount Refunded	$257,855.30	$291,858.99	$389,412.53	$258,502.27
Percentage refunded:				
Wholly by check	15.6%	13.6%	12.9%	14.8%
Partially by check	26.7	23.8	18.1	27.5
Credit against bill	57.7	62.6	69.0	57.7

In his notice of deficiency, the Commissioner determined, among other adjustments, that the petitioner was required to include in income the balance of customer deposits outstanding as of December 31, 1975, less deposits attributable to the period prior to 1954.[3] He also determined that the increase or decrease in the amount of the customer deposits on hand at the end of 1976 and 1977 represented an increase or decrease in the petitioner's income for each year, as the case may be. All other adjustments proposed in the notice of deficiency have been resolved by the parties.

OPINION

The only issue for decision is whether the customer deposits received by the petitioner were includable in income upon receipt as advance payments.

Section 61(a) of the Internal Revenue Code of 1954[4] defines gross income as all income from whatever source derived, including compensation for services and gross income derived from business. Moreover, section 451(a) and

[3] See note 2, *supra*.

[4] All statutory references are to the Internal Revenue Code of 1954 as in effect during the years in issue.

section 1.451-1(a), Income Tax Regs., state the general rule that any item of gross income shall be included in gross income for the year in which it is received by the taxpayer unless, under an acceptable accounting method, it may be properly accounted for in some other period. Advance payments of income are income in the year received. *Schlude* v. *Commissioner,* 372 U.S. 128 (1963); *American Automobile Assn.* v. *United States,* 367 U.S. 687 (1961); *Automobile Club of Michigan* v. *Commissioner,* 353 U.S. 180 (1957). However, so-called "deposits" received by a taxpayer have, on occasion, been held not to be includable in gross income on receipt. E.g., *Mantell* v. *Commissioner,* 17 T.C. 1143 (1952). The courts have differed over the criteria to be used in distinguishing deposits from advance payments.

In *City Gas Co. of Florida* v. *Commissioner,* 74 T.C. 386 (1980) (*City Gas I*), the taxpayers, one regulated public utility and two nonregulated companies, were engaged in the business of selling gas to both residential and commercial customers. The companies requried all new customers to make deposits which were to be refunded or credited to the customer's account, at the company's choice, upon termination of service or upon the company's prior election. Each of the companies reported the deposits as current liabilities, and the regulated company paid interest on the deposits. The deposits were generally credited against a customer's final bill and any balance was refunded by check. Any deposit that was not refunded to a customer within 15 years after termination of service escheated to the State. We stated the rules for distinguishing deposits and advance payments to be:

> Advance payments to which a taxpayer-recipient has a present right, and over which he has unrestricted control, are income upon receipt, even though they are refundable under certain circumstances. *Hagen Advertising Displays, Inc.* v. *Commissioner,* 407 F.2d

1105, 1107 (6th Cir. 1969), affg. 47 T.C. 139 (1966) (payments for advertising signs); *Van Wagoner* v. *United States,* 368 F.2d 95, 97-98 (5th Cir. 1966) (5-percent commissions on "deposit premiums" received by insurance agency partnership); *BJR Corp.* v. *Commissioner,* 67 T.C. 111, 121-123 (1976) (advance rents for use of mobile homes). If, on the other hand, an amount is deposited with a taxpayer as a security payment which is to be returned, it is not income, although the taxpayer has temporary use of the money. *Mantell* v. *Commissioner,* 17 T.C. 1143, 1145, 1148 (1952) (security deposit for lessees' performance of numerous lease covenants). See *Warren Service Corp.* v. *Commissioner,* 110 F.2d 723, 724 (2d Cir. 1940), affg. on this ground 39 B.T.A. 856 (1939). * * * [74 T.C. at 391.]

We analyzed all of the surrounding facts and circumstances and determined that the amounts in issue were received as security deposits subject to refund and, therefore, did not constitute income. The rationale for this conclusion was:

> Thus, although petitioners had temporary use of the customer deposits from the time of receipt, the deposited amounts were not advance payments for service but rather security to assure that the customer would pay all bills upon termination of the service. At all times, the deposits were treated as liabilities which petitioners owed to their customers subject to the deposit agreements. Those liabilities could be discharged only by applying the deposited amounts against unpaid bills for gas service and a variety of charges or by refunding them to the customers. Accordingly, we do not think any of the amounts at

issue constituted income to petitioners when the deposits were received. [Fn. ref. omitted.]

* * *

In contrast, the full amount of a deposit received by one of petitioners was, unconditionally, subject to refund to the customer. If the refund was not effected, the amount would ultimately escheat to the State. Although the total deposit might be applied against amounts owed a petitioner upon customer termination of his account, or at petitioners' prior election, the right of petitioners to any part or all of the deposit was not fixed and could not be determined when the deposit was made. Indeed, unlike a tenant under a lease, a gas customer did not contract for services for any stated period or periods but could terminate service at any time. Petitioners became entitled to apply all or part of the deposited amounts only if a customer otherwise failed to pay all charges due at the termination of service. [74 T.C. at 393-394.]

In *City Gas Co. of Florida* v. *Commissioner,* 689 F.2d 943 (11th Cir. 1982) (*City Gas II*), the Court of Appeals for the 11th Circuit reversed and remanded the case. The Court of Appeals noted that a payment for a customer deposit to a utility company often serves mixed purposes; "it may serve both as security for property or performance of nonincome-producing covenants and also as a prepayment of bills, rent, or other charges for goods and services." 689 F.2d at 946. The Court of Appeals held that if the primary purpose of a customer deposit is to act as a prepayment for goods and services, then the amount of the deposit is includable in income upon receipt; if the primary purpose of the deposit is to secure performance of nonincome-producing covenants or to secure against

damage to property, then the amount of the deposit is not includable in income upon receipt. In footnote 7, the Court of Appeals recognized the importance of taxpayer control over customer deposits in determining whether or not such deposits are income upon receipt when it stated:

> . If on remand the Tax Court concludes that the primary intent was that the sums at issue be applied to discharge income items on the final bill (e.g., charges for gas, turn-on and turn-off and other service charges), the fact that the sums were labeled as "deposits to secure payment" cannot by itself preclude a finding that the sums were intended as prepayments. Although several courts have mentioned the "security" label as one factor, * * * we have found no case which would support a finding for the taxpayer where sums labeled as a "deposit" or "security" were subject to the unrestricted control of a taxpayer with a present right thereto and were intended to be applied against income items. The case law requiring a finding for the Commissioner under such circumstances, * * * is based, we think, upon the unarticulated rationale that under such circumstances the sums are in substance prepayments. * * * We express no opinion with respect to the substance of payments under other circumstances, e.g., where sums intended to secure payment of future income items are deposited in escrow and taxpayer must foreclose to assert its security interest. * * * [689 F.2d at 948; citations omitted.]

Because the Tax Court had not applied this primary purpose test, the Court of Appeals remanded the case for further proceedings.

On remand, in *City Gas Co. of Florida* v. *Commissioner,* T. C. Memo. 1984-44 (*City Gas III*), this Court

stated that, under the test adopted by the Court of Appeals, "deposits must be categorized either as prepayments for goods and services on the one hand, or as security for the performance of nonincome-producing covenants on the other. The Eleventh Circuit, as we understand it, did not admit of the possibility of other categories." 47 T.C.M. 971 at 973; 53 P-H Memo T. C. par, 84,044 at 84-163; footnote reference omitted. We concluded that the primary purpose of the customer deposits was to act as a prepayment for gas consumed, and thus, the amount of the deposits was includable in income.

As might be expected, the Commissioner requests that we adopt the reasoning set forth in *City Gas II* in resolving the case at hand and argues that the primary purpose test set forth in *City Gas II* "sets forth a logical, predictable rule of consistency" and that "determining whether the deposits secured the payment of future income or non-income producing covenants is consistent with accepted precedent." He cites *Van Wagoner* v. *United States,* 368 F.2d 95 (5th Cir. 1966); *August* v. *Commissioner,* 17 T.C. 1165 (1952); *Gilken Corp.* v. *Commissioner,* 10 T.C. 445 (1948), affd. 176 F.2d 141 (6th Cir. 1949); and *J. and E. Enterprises, Inc.* v. *Commissioner,* T. C. Memo. 1967-191, as supporting the proposition that security deposits that secure future income are taxable upon receipt by the taxpayer. On the other hand, the petitioner believes that our opinion in *City Gas I* reflects judicial wisdom and urges us to continue to follow that precedent.

In *Van Wagoner* v. *United States, supra,* certain purchasers of insurance were required to pay "deposit premiums" at the inception of their insurance policies, and the taxpayers, partners in an insurance agency, retained 5 percent of such deposit premiums. The taxpayers also retained as their commission 5 percent of the total premiums paid by the insureds over the life of the policy. The

amounts received as deposit premiums "were under complete, free and unrestricted control of the taxpayers who were obligated to refund an equivalent amount if the insured complied with all the terms of the policy." 368 F.2d at 97. The taxpayers invested their shares of the deposit premiums but paid no interest to the insureds for the use of such funds. At the expiration of the policy term, the amount of the deposit premium was credited to an insured's account and any excess was refunded to him, or if the policy was renewed, he was given a credit on the premium for the new policy. The Court of Appeals agreed with the district court that the deposit premiums were advance premiums, paid in place of a regular premium at the inception of each policy. The court noted that the taxpayers retained the same percentage from the deposit premiums as they did from total premium payments, that the taxpayers had complete and unrestricted control over the deposit premiums, and that they paid no interest on the deposits.

In *August* v. *Commissioner, supra,* the taxpayers were partners in a partnership which entered into two leases with the lessee. In the first lease, the term was from May 1945 through April 1950, for a total rent of $140,000, which included $28,000 to be paid to the taxpayers prior to the beginning of the lease term. The lessee was to pay $28,000 a year in rent for the first 4 years of the lease and no rent during the last year of the lease. In addition, the lease called for a "security payment" of $4,000 as security for the lessee's performance of the terms of the lease. In December 1945, the second lease was executed. Such lease was a renegotiation of the first lease, designed to provide tax benefits to the taxpayers, and was for a term from December 1945 through May 1950. Such lease called for a $32,000 security payment: $28,000 at the time of execution and $4,000 in 1949. The rent payment terms were the same

as those set forth in the first lease, except that during the last year of the lease, $28,000 in rent was to be paid in 10 payments, and 6 days after each such payment, a check for the same amount as such payments was to be paid to the lessee by the taxpayers. Such payments to the lessee were alleged to be a return of the $28,000 that he paid at the time of execution. In fact, during 1950, the lessee and the taxpayers met several times and exchanged checks for identical amounts. This Court concluded that the amount of $28,000 was an advance rental payment and, therefore, includable in the taxpayer's income for 1945. In arriving at this conclusion, we stated that the first lease expressed the intent of the parties that the $28,000 payment was not a bona fide security deposit and that the exchange of checks in 1950 had the practical effect of applying the $28,000 paid in 1945 toward the rent due for the last year of the lease.

In *Gilken Corp.* v. *Commissioner, supra,* the lessee of an apartment hotel paid the taxpayer certain amounts of money described as being security for the lessee's performance of lease obligations. Under the lease, and an amendment thereto, if the lessee faithfully performed the conditions of the lease, such security was to be applied to the last 5 month's rent of the lease, or if the lessee desired to exercise his purchase option, such security was to be credited to the purchase price. No interest was to be paid on the security deposit. We concluded, notwithstanding the option price credit provision, that the security payments were advance payments of rent, taxable upon receipt. We found that the money was subject to the taxpayer's unrestrained control and that the "primary purpose" of the payments was advance payment of rent.

In *J. and E. Enterprises, Inc.* v. *Commissioner, supra,* the taxpayer, as lessor, entered into two leases, each of

which required a "security deposit." At the taxpayer's option, the deposits could be returned to the lessee, or applied to the rent payable during the last year of the lease. In addition, the taxpayer was not required to pay interest on the deposits or to segregate the deposit funds. In stating the relevant law, we said:

> If, on the other hand, a sum is deposited to secure the lessee's performance under a lease, and is to be returned at the expiration thereof, it is not taxable income even though the fund is deposited with the lessor instead of in escrow and the lessor has temporary use of the money. * * * In this situation the acknowledged liability of the lessor to account for the deposited sum on the lessee's performance of the lease covenants prevents the sum from being taxable in the year of receipt. * * *
>
> The question of which rule is applicable must be resolved by reference to the intention and conduct of the parties as ascertained from the lease agreement and the related circumstances. * * * [26 T.C.M. 944 at 946, 36 P-H Memo T.C. par. 67,191 at 67-1033; citations omitted.]

We concluded that the security deposits were includable in income in the year received by the taxpayer because such deposits were under the exclusive and unfettered control of the taxpayer and because the circumstances under which the deposited sum might be returned to the lessee were within the exclusive control of the taxpayer.

After reviewing these cases, we conclude that they do not support the rule articulated by the 11th Circuit which is urged upon us by the Commissioner. In these cases, the courts looked at the facts and circumstances surrounding the deposit to determine whether or not the primary purpose of the deposit was to be an advance payment. Of par-

ticular importance in these cases was whether the taxpayer had control over the deposit during the term of the lease and upon its expiration and whether interest was paid on the amount deposited. See *City Gas I*, 74 T.C. at 394-395. Where the taxpayer has virtually unrestricted control over the amount deposited and does not pay interest on such amount, the amount has been considered an advance payment of income. See *Hirsch Improvement Co.* v. *Commissioner*, 143 F.2d 912 (2d Cir. 1944); *Astor Holding Co.* v. *Commissioner*, 135 F.2d 47 (5th Cir. 1943).

In our judgment, we should continue to examine all of the facts and circumstances surrounding a deposit to evaluate the rights retained by the depositor and the rights acquired by the holder of the deposit. In the present case, it is very significant that most customers were not required to make deposits. In the *City Gas* cases, all new customers were required to make the deposits, and in the other cases relied on by the Commissioner, the lessees or other purchasers of services were generally all required to make deposits. If a deposit is intended as a means of obtaining an advance payment of income, it is apt to be required of all participants; the fact that this petitioner required only 5 percent of its customers to make deposits is highly persuasive evidence that the deposits were not intended as advance payments. In addition, the fact that creditworthiness was the criteria used in determining such customers, indicates that the deposits were not intended as advance payments.

Moreover, in the present case, the depositor—the customer—had the right to control the ultimate disposition of the deposit. Prior to the 1976 amendments of the rules of service, a customer could secure a refund of his deposit by requesting it, if he then met the petitioner's creditworthiness standards. After those amendments of the rules of service, the standards for determining creditworthiness were made explicit, and if a customer paid his bills when due, his deposit was automatically refunded to him in a year or so. Only those customers who did not pay their bills were unable to secure a refund of their deposits. In fact, it was more convenient for the customer and the petitioner to credit a refund against a bill, and therefore, many of those customers who were entitled to a refund of their deposits elected to have the deposits credited against their bills. The petitioner took reasonable steps to inform the customers of their rights to the deposits, and the facts that between 31 and 42 percent of the dollar amount of deposits refunded annually were by check shows that they were aware of their rights to a refund by cash or check.

The petitioner's rights in the ultimate disposition of the deposits were minimal. Only when a customer failed to pay his bills did the petitioner have a right to decide how the deposits were to be used; only then could the petitioner decide that the deposits were to be used to pay for electricity or services. Thus, in general, the deposits that were collected by the petitioner were held as security for the customer's payment of his bills; only when those bills were not paid did the deposits become payments for electric or steam service. In addition, the petitioner did not benefit from the deposits that were unclaimed by the customer or not credited to bills; the unclaimed deposits escheated to the State after 7 years.

Finally, the petitioner consistently treated the deposits as belonging to the customers. When a customer made a deposit, he was given a receipt stating that the deposit was to "insure prompt payment for electric service, steam service, or both" and that such deposit would be refunded "after Service has been disconnected and all bills due have been paid." Also, the customer received interest on his deposits—at the rate of 3 percent per annum before the

amendments of the rules of service in 1976 on deposits held at least 6 months, and 6 percent per annum thereafter on deposits held more than 12 months. In accounting for the deposits, the petitioner treated them as current liabilities. Such treatment was required by the rules of service. In paying interest on the deposits and in the accounting treatment of them, the deposits were treated like loans obtained by the petitioner.[5] Under the circumstances, we are convinced that the deposits were not advance payments of income but were temporarily held by the petitioner to secure payment of the bills and were not therefore includable in gross income.[6]

Each of the parties also argues that its position is supported by the *Illinois Power* cases. In *Illinois Power Co.* v. *Commissioner*, 83 T.C. 842 (1984), the Illinois Commerce

[5] Cf. *Iowa Southern Utilities Co. v. United States*, 11 Cl. Ct. 868 (1987), wherein surcharge revenue to the taxpayer, an electric company, was found not to constitute a "loan" from its customers. The surcharge was intended to finance the construction of a power plant. After the power plant went into operation, the amount collected by the surcharge was to be refunded to customers over a period not to exceed 30 years, in the form of a negative surcharge. The court found that the surcharge was treated as a charge for electricity for customer billing and State sales tax purposes, that no customer was ever advised of the loan arrangement, and that repayment would benefit all the taxpayer's customers without regard to whether they had paid the surcharge.

[6] Unlike *Oak Industries, Inc.* v. *Commissioner*, T. C. Memo. 1987-65, on the evidence before us, we cannot conclude that the customer deposits were intended to be used against balances due for services upon termination. In *Oak Industries*, all or a portion of the customer deposits were credited to final bills for between 61 and 70 percent of all customer terminations. In that case, all customers had to pay a customer deposit, the taxpayer paid no interest on customer deposits, and the taxpayer had a very well developed delinquent account collection system.

Commission (ICC), which regulated the taxpayer's rates, created in 1974 a new gas rate classification, which had the effect of raising rates for certain commercial customers. The principal purpose of the new rate classification was to induce such customers to convert to an alternative fuel. The ICC made clear that this was its purpose. The ICC ordered that some of the revenue received by the taxpayer as a result of such rate classification be placed in a special fund and stated that the taxpayer would not be able to keep the money that was placed in such fund. But, it did not specify the manner in which the taxpayer would have to dispose of the money in such fund or whether the taxpayer had to pay interest on the fund, nor did it require the special fund be segregated from the taxpayer's other funds. As a consequence, the taxpayer commingled money in the special fund with money from other funds; the special fund existed only as a series of bookkeeping entries. In 1979, the ICC determined that the special fund should accrue interest at a statutory rate and that the fund should be paid to certain customers (not the same customers who paid the new gas rate) through a monthly credit against such customers' gas bills. The Commissioner took the position that the taxpayer had a right to the fund and that therefore the fund was includable in its gross income. We applied the claim of right doctrine[7] and sustained such position. 83 T.C. at 895-898.

The Court of Appeals for the Seventh Circuit reversed our decision. *Illinois Power Co.* v. *Commissioner*, 792 F.2d 683 (1986). The Court of Appeals noted that the fact that the special fund was not segregated from the tax-

[7] *North American Oil* v. *Burnet*, 286 U.S. 417 (1932).

payer's other funds was of little importance and concluded that the taxpayer was:

> a custodian, a tax collector, with no greater beneficial interest in the revenues collected than a bank has in the money deposited with it.
>
> • • •
>
> Where, unlike the case of a trustee or a collection agent or a borrower, the taxpayer's obligation to refund or rebate or otherwise repay money that he has received is contingent, the money is taxable as income to him. See, e.g., *Nordberg* v. *Commissioner*, 79 T.C. 655, 663-68 (1982), affd. without opinion, 720 F.2d 658 (1st Cir. 1983); Dubroff, "The Claim of Right Doctrine," 40 Tax L. Rev. 729 (1985). • • • Prepayment of money owed, as in the case of a rent "deposit" that is to be applied to the last month of the lease, is treated as income when received, if the purpose is to pay for goods or services in advance rather than to secure the lessee's good behavior (in which event it must be refunded unless he misbehaves). See *City Gas Co.* v. *Commissioner*, 689 F.2d 943 (11th Cir. 1982), and cases cited there. There is nothing like that here; there is even less contingency than in the case of a lessee's security deposit, which when bona fide is, as just suggested, excluded from income. See *Clinton Hotel Realty Corp.* v. *Commissioner*, 128 F.2d 968 (5th Cir. 1942). • • •
>
> • • •
>
> The underlying principle is that the taxpayer is allowed to exclude from his income money received under an unequivocal contractual, statutory, or regulatory duty to repay it, so that he really is just the custodian of the money. • • • [792 F.2d at 689.]

The issue and facts in the *Illinois Power* cases are, however, significantly different from those in the present

case. In the *Illinois Power* cases, the issue, as framed by the parties and as decided by the court, involved the applicability of the claim of right doctrine. 83 T.C. at 895-898; 792 F.2d at 689-690. The special gas rate was in effect an energy tax. The customers were required to pay it and they had no right to receive a refund of it. On the other hand, although the special fund was collected by the taxpayer, the ICC made clear, from the outset, that the taxpayer would not be allowed to keep the fund. Thus, the issue did not involve the tax treatment of deposits, and the rights to the special fund were significantly different from those of a depositor and a holder of deposits. In our judgment, the *Illinois Power* cases are distinguishable; nevertheless, it is interesting to observe that the effect of the decision by the Court of Appeals is to hold that the taxpayer was not taxable on the special fund to which it had no rights and that such result is similar to our conclusion that the petitioner is not taxable on the deposits with respect to which it had only minimal rights.

Decision will be entered under Rule 155.

Reviewed by the Court.

STERRETT, CHABOT, NIMS, PARKER, WHITAKER, SHIELDS, HAMBLEN, COHEN, CLAPP, SWIFT, JACOBS, WRIGHT, PARR, WILLIAMS, and WELLS, *J.J.*, agree with this opinion.

APPENDIX C

UNITED STATES COURT OF APPEALS
For the Seventh Circuit

No. 87-2438

INDIANAPOLIS POWER AND LIGHT COMPANY,
PETITIONER-APPELLEE

vs.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT-APPELLANT

September 20, 1988

APPEAL FROM A DECISION OF THE UNITED STATES TAX COURT

[Entered Sept. 20, 1988]

JUDGMENT – ORAL ARGUMENT

Before: Hon. WILLIAM J. BAUER, Chief Judge; Hon. JOEL M. FLAUM, Circuit Judge; Hon. MICHAEL S. KANNE, Circuit Judge.

This cause was heard on the record from the United States Tax Court, and was argued by counsel.

On consideration whereof, IT IS ORDERED AND ADJUDGED by this Court that the Tax Court's decision is AFFIRMED, with costs in accordance with the opinion of this Court filed this date.

U.S. GOVERNMENT PRINTING OFFICE 1989—241 699 00070

OPPOSITION

BRIEF

(2)

No. 88-1319

Supreme Court, U.S.
FILED
MAR 30 1989
JOSEPH F. SPANIOL, JR.
CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1988

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

INDIANAPOLIS POWER & LIGHT COMPANY,
Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

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RESPONDENT'S BRIEF IN OPPOSITION

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20 pp

QUESTION PRESENTED

Whether refundable security deposits collected by a public utility from a limited class of customers and returned when the customers establish creditworthiness are includible in the utility's income?

RULE 28.1 LISTING

The sole parent company of respondent is IPALCO Enterprises, Inc. Respondent has no subsidiaries except wholly-owned subsidiaries. Respondent's sole affiliate is Mid-America Capital Resources, Inc.

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No. 88-1319

In the Supreme Court of the United States

OCTOBER TERM, 1988

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

INDIANAPOLIS POWER & LIGHT COMPANY,
Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

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RESPONDENT'S BRIEF IN OPPOSITION

STATEMENT OF THE CASE

1. Respondent Indianapolis Power & Light Company ("IPL") is a regulated public utility engaged in generating and selling electricity and steam in Indianapolis, Indiana, and neighboring areas. (Pet. App. 2a and 20a). During the years in issue, IPL collected security deposits from approximately 5% of its customers who could not meet creditworthiness standards. The receipt issued to such customers stated that the deposits were "to insure prompt payment of electrical service." (Pet. App. at 2a). Commercial customers often made different

arrangements in lieu of cash deposits, including submission of letters of credit or the pledge of assets. (Pet. App. at 20a). When a customer demonstrated creditworthiness, the deposit was refunded. (Pet. App. at 2a). Unclaimed deposits escheated to the state. (Pet. App. at 4a).

Prior to March 10, 1976, the determination of whether a deposit was required was based on a creditworthiness analysis, but no fixed formula was used. (Pet. App. at 2a). As a result of an amended regulation by the Public Service Commission of Indiana, effective March 10, 1976, a fixed formula was prescribed thereafter for residential customers. Deposits could be required of new residential customers who failed the prescribed test and existing residential customers who had a history of late payments. The amended rules also required IPL to increase the rate of interest payable on deposits held for more than twelve months from 3% to 6%. (Pet. App. at 3a).

Prior to March 10, 1976, a customer could obtain a refund of the deposit by requesting such a refund and demonstrating his or her creditworthiness. (Pet. App. at 2a). Such a refund was usually made in cash or by check but could be credited to the customer's bill if the customer requested. (Pet. App. at 22a). The manner in which such refund was made was determined by the customer. (Pet. App. at 3a).

After March 10, 1976, a residential customer's deposit was refunded if the customer paid his or her bill on a timely basis for nine consecutive months or for ten out of twelve months (as long as the two delinquent months were not consecutive). Alternatively, the customer could obtain a refund by satisfying the prescribed creditworthiness test. These refunds were made in cash or by check unless the customer requested an offset against the bill. Upon termination of service, the deposit was

generally offset against the customer's final electric bill unless the customer requested otherwise. (Pet. App. at 3a). During the years in issue, 31% to 42% of the refunds were actually returned in the form of cash or checks. (Pet. App. at 25a).

IPL did not segregate the customer deposits from its other assets. (Pet. App. at 3a). IPL was required by the rules of service of the Public Service Commission of Indiana to treat unrefunded deposits as liabilities and not as income for regulatory accounting purposes. (Pet. App. at 4a, n. 3). Such treatment was in accord with generally accepted accounting principles and clearly reflected income for financial accounting purposes. (Pet. App. at 24a).

2. IPL consistently applied this same accounting approach for both financial accounting and tax purposes for at least fifty years. (Stip. Facts ¶ 20; and Tr.11). Petitioner Commissioner of Internal Revenue (the "Commissioner") first questioned this treatment in connection with IPL's 1975 taxable year, taking the position that such deposits were in reality advance payments and should be included in IPL's income for that year. (Pet. App. at 1a).

In a unanimous opinion reviewed by the full court, the Tax Court rejected the Commissioner's challenge to IPL's treatment and found that the refundable deposits collected by IPL from its noncreditworthy customers were not includible in its income. (Pet. App. at 19a-39a). In reaching this decision, the Tax Court's inquiry was directed at evaluating all the facts and circumstances to determine "the rights retained by the depositor and the rights acquired by the holder of the deposit." (Pet. App. at 34a). In evaluating those rights, the Tax Court found it significant that the deposits were not intended as advance payments; the depositor--the customer--had the right to control

the ultimate dispostion of the deposit and IPL's rights in the dispositon of the deposit were minimal; and IPL treated the deposits as belonging to the customer and paid interest on the deposits. (Pet. App. at 34a-36a). On appeal the Court of Appeals for the Seventh Circuit affirmed the Tax Court's decision, holding that the deposits served as security and not as prepayments. (Pet. App. at 17a).

One other circuit has addressed the taxability of utility customer deposits. In *City Gas of Florida v. Commissioner*, 689 F.2d 943 (11th Cir. 1982), *rev'g and remanding* 74 T.C. 386 (1980), the customer deposits were held to be taxable. However, that case involved a fact situations different from IPL's because the customer deposits in question were collected from all new customers, not just those of doubtful creditworthiness, and were earmarked for and applied to the payment of final bills without the possibility of refund when the customer achieved creditworthy status.

REASONS FOR DENYING THE WRIT

The Commissioner has requested the Court to grant review of the decision below because of a perceived conflict between the Court of Appeals' decision and the Eleventh Circuit decision in *City Gas*, and because the Commissioner seeks a *per se* rule that would purportedly ease tax administration by resolving all disputes in the government's favor.

IPL submits that the decision of the Court of Appeals does not warrant review. First, the facts in this case are different in important respects from those presented to the Eleventh Circuit

in *City Gas*. Second, the two courts' respective statements of the basic legal test for distinguishing nontaxable security deposits and taxable advance payments are not contradictory. The courts reached different conclusions because the factual settings involved were not comparable. The decisions thus do not present the type of irreconcilable conflict between circuits that might otherwise be an appropriate occasion for this Court to exercise its discretion to review the issue at this time. Third, the decision below is clearly correct. The issue does not lend itself to a uniform *per se* rule that would be faithful to this Court's precedents and and to the economic substance of the underlying transactions. The Court of Appeals recognized this latter point and found it appropriate to "retain the traditional approach of analyzing the facts and circumstances to determine whether the principal purpose of a 'deposit' is to secure future performance or to serve as an advance payment of income." (Pet. App. at 16a).

I. *The Decisions of the Eleventh Circuit in* City Gas *and the Seventh Circuit in This Case Do Not Present an Irreconcilable Conflict.*

A. *The Cases Involve Different Fact Situations.*

Major factual distinctions exist between *City Gas* and the present case. The deposits in *City Gas* were collected from all new customers, were held by the utilities until the customer terminated service, and were then applied against final utility bills. 74 T.C. at 389 and 392. In addition, two of the three utilities paid no interest on the deposits. 74 T.C. at 389. By contrast, the deposits in IPL's case were collected from a small percentage of customers found to be noncreditworthy and were refundable with interest upon a customer establishing his creditworthiness, a condition which was within the customer's con-

trol. The deposits were thus not earmarked for payment of the final bills as in *City Gas*.[1]

As discussed below, the Seventh Circuit and the Eleventh Circuit agree that whether a deposit constitutes income at the time of receipt depends on the primary purpose for which the deposit was obtained. Deposits collected from all customers for the purpose of application against final bills for utility services present a quite different situation from refundable deposits collected from a limited class of customers. The Eleventh Circuit did not have occasion to address the taxability of deposits of the quite different type involved in this case, stating that "[w]e express no opinion with respect to the substance of payments under other circumstances . . .." 689 F.2d at 948, n. 7. The fact that the two courts reached different results on different facts does not give rise to the type of irreconcilable conflict between the circuits that might otherwise warrant review of the issue by the Court at this time.

B. *The Two Cases Do Not Present A Direct Conflict on the Law.*

As stated by both the Eleventh Circuit and the Seventh Circuit, the basic test for distinguishing true deposits from

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[1] In *City Gas*, the Eleventh Circuit stated that if the "primary intent" of the parties was that the deposits "be applied to discharge income items on the final bill," the deposits would constitute the advance payment of the final bill even if they were labelled as "deposits to secure payment." 689 F.2d at 948, n.7. On remand, the Tax Court found that the only reasonable inference from the facts and circumstances was that the parties intended the deposits to be applied in payment of final utility bills. *City Gas of Florida v. Commissioner*, 47 T.C.M. 971, 973-974 (1984).

advance payments requires a facts and circumstances analysis. The Eleventh Circuit in *City Gas* phrased the test as follows:

> In sum, we conclude that, consistent with the above former Fifth Circuit precedent, the test to be applied in this case is whether, under all the circumstances, the primary purpose of the payments at issue was a prepayment of income items, or whether the primary purpose was to secure the performance of nonincome-producing covenants.

689 F.2d at 948. Similarly, the Seventh Circuit in this case found as the proper approach "to look at the primary purpose of the deposit based on all the facts and circumstances" (Pet. App. at 11a) and to determine whether the "principal purpose of a 'deposit' is to secure future performance or to serve as an advance payment of income" (Pet. App. at 17a).

The Fifth Circuit precedent referred to in *City Gas* was part of a series of cases distinguishing the taxable receipt of an advance payment of rent from the nontaxable receipt of a tenant's security deposit. The payment of a sum earmarked for application to a fixed rental payment for a specific lease period, such as the final month's rental bill, was consistently held to constitute an advance payment of rent.[2] However, there were certain cases where the payments had a dual purpose -- (1) an advance payment of rent if held by the landlord until the end of the lease term and applied to the final month's rental bill and (2) a security deposit to protect the landlord during the lease term against breach by the tenant, for example, in the case of

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[2] *See, e.g., Astor Holding Company v. Commissioner*, 135 F.2d 47 (5th Cir. 1943).

damage to the premises.[3] The Eleventh Circuit concluded that the courts had resolved the latter cases by applying a primary purpose test -- the payment is taxable if, of the two purposes, the primary purpose is the advance payment of rent. Obviously, this analysis need be applied only after a determination that one of the deposit's purposes is to prepay income.

In *City Gas*, the Eleventh Circuit plainly believed that it had such dual-purpose deposits before it. Because of the certainty that the deposits would not be refunded but would be applied against a taxpayer's final utility bill, either upon default or upon termination of service, the Court was convinced that at least one purpose of the deposit was to prepay the final bill for services. It left it to the Tax Court to determine on remand whether that was the primary purpose or whether some other possible application, such as use as a damage deposit, was primary.

However, when, as in this case, the facts and circumstances establish that a deposit is refundable upon conditions under the customer's control, and is not earmarked as payment of a customer's final utility bill, such a deposit does not have as one of its purposes the prepayment of the final month's bill. Instead, it is intended solely as a stand-by security device to protect the taxpayer against interim defaults by uncreditworthy customers. Once its purpose as security becomes inapplicable, because the customer has established creditworthiness, the deposit is refunded. In such a case it is not necessary to weigh an advance

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[3] *See, e.g., Clinton Motel Realty Corp. v. Commissioner*, 128 F.2d 968 (5th Cir. 1942); *Hirsch Improvement Co. v. Commissioner*, 143 F.2d 912 (2d Cir. 1944), *cert. denied*, 323 U.S. 750 (1944); *Mantell v. Commissioner*, 17 T.C. 1143 (1952).

payment purpose against some other purpose, as the Eleventh Circuit believed was necessary on the facts before it in *City Gas*.

Both the Seventh Circuit and the Eleventh Circuit applied a basic facts and circumstances analysis and reached different results on very different facts. Thus, the cases do not stand in conflict with each other on fundamental principles of law any more than they do on matters of fact. If otherwise appropriate, review of the utility deposit issue should be deferred by this Court until such time as an actual conflict develops as a result of decisions by circuit courts that are based on comparable facts or clearly contradictory legal approaches.[4]

II. *The Court of Appeals' Decision Was Correct and in Accord with Controlling Principles of Tax Law.*

The Court of Appeals emphasized the limited scope of its holding based on the specific facts of the case. (Pet. App. at 16a). In this connection, the Court found that three primary facts supported the Tax Court's determination that the customer deposits were not taxable prepayments. First, IPL never intended that the deposits serve as prepayments. Instead, it intended them to be a security device and collected them from only about 5% of its customer base. Second, the depositor was the party with the right to control the ultimate disposition of the deposit because he could secure a refund of the deposit simply by demonstrating his creditworthiness. Thus, IPL had minimal

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[4] In this regard, IPL notes that another case involving approximately $100 million of deficiencies attributable to refundable interest-bearing customer security deposits has recently been instituted in the United States Tax Court. *American Telephone and Telegraph Co. and Consolidated Subsidiaries v. Commissioner*, Tax Court Docket No. 2737-89 (filed February 9, 1989). This case would be appealable to the Court of Appeals for the Second Circuit.

rights in the deposit because it was legally obligated to account to the customer for the deposit unless the customer defaulted before making the demonstration of creditworthiness and receiving the refund. Only in the latter situation was IPL entitled to dispose of the deposit by applying it against the customer's unpaid bills. Third, IPL was obligated to pay and did pay interest on the deposits. (Pet. App. at 6a and 17a).[5]

By focusing on the benefits that IPL received and did not receive as a result of temporarily holding the refundable customer deposits, the Court of Appeals was simply following controlling precedent of this Court. In *James v. United States*, 366 U.S. 213 (1961), the Court dealt with the tax treatment of embezzled funds but also addressed the general standards for determining whether amounts are includible in gross income. Under those standards, amounts are includible as income only if they are obtained "without the consensual recognition, express or implied, of an obligation to repay and without restriction as to their disposition" 366 U.S. at 219. As the Court stated, "[t]his standard excludes loans." *Id*. The receipt and temporary use of loaned funds, subject to a repayment obligation, do not provide the taxpayer with the "accession to wealth" necessary to warrant their inclusion in gross income. The customer deposits received by IPL in this case were similarly

[5] Other facts supported the decision as well. Unclaimed deposits escheated to the state. IPL could not retain them. In addition, IPL consistently treated deposits as belonging to customers and provided customers with receipts stating their right to a refund of the deposit. Finally, under mandatory rules promulgated by the Public Service Commission of Indiana, IPL was required to record the deposits as liabilities on its books. (Pet. App. at 4a). That treatment was in accord with generally accepted accounting principles. (Pet. App. at 24a).

subject to an acknowledged obligation of repayment and did not result in an accession to IPL's wealth that should lead to taxation.

Notwithstanding the above, the Commissioner argues that the sixteen judges of the Tax Court who agreed with the court-reviewed decision, as well as the Court of Appeals which affirmed it, erred in holding that the deposits were not income to IPL. With all respect, the Commissioner's arguments do not withstand scrutiny.

First, the Commissioner notes that a deposit had the same effect on IPL's cash flow as an advance payment of income. (Pet. at 11). However, the mere fact that IPL received cash and commingled it with its other funds cannot justify taxation of the deposits. Otherwise, loan receipts, bank deposits, cash bonds, and property damage deposits would all be taxable to the recipient as well. The cash flow similarities are essentially irrelevant to the question whether income was received.

Second, the Commissioner attempts to equate the economic substance of IPL's refundable customer deposits with the advance payment of utility bills. (Pet. at 11-12). However, the economic substance is clearly not the same because the deposits received were *temporary security* for the payment of bills, which is simply not the same thing as the *payment* of the bills. Absent a prior default by the customer, IPL had an unequivocal obligation to refund the deposit to creditworthy customers and had no right to apply the deposit to the customer's debt. The *timing* of the refund was controlled by the customer, either by improving his credit standing by prompt bill payment or otherwise or by terminating his utility service. The *manner* of the refund, either by cash, check, or a credit against a utility bill, was also determined by the customer. (Pet. App. at 3a). The

issuance of a cash or check refund to customers was not the same as a bilateral exchange of checks lacking substance. In this connection, the timing and amount of deposit refunds would be unlikely to match the customer's obligations to pay for utility services, which would vary over time with usage. Finally, unclaimed deposits escheated to the state. There is a fundamental difference between a refundable customer deposit and an amount irrevocably earmarked as the advance payment of income.

Third, the Commissioner questions the Court of Appeals' conclusion that economic considerations undermine a per se rule that treats deposits primarily securing income-producing covenants as always taxable and treats deposits primarily securing non-income producing covenants as always non-taxable. (Pet. at 12). However, the Court of Appeals was correct in its conclusion because the nonrecognition of income upon the receipt of a damage deposit is not properly based on the nature of the covenants secured but, instead, is based on the deposit holder's lack of significant rights in the deposit prior to the depositor's default -- the same consideration that justifies the nonrecognition of income upon the receipt of a deposit securing the payment of future utility bills. (Pet. App. at 12a).

Finally, the Commissioner questions the importance of the payment of interest as a factor in evaluating the taxability of a deposit. (Pet. at 12). While the payment or nonpayment of interest was a "very important" factor in the Court of Appeals' view, it would normally be only one of several factors that would have to be considered. (Pet. App. at 17a, n.12). The Court of Appeals' point was that, when interest is payable, the real value of the deposit lies in its benefit as a security device and not in the return the holder might be able to earn on the funds. (Pet. App. at 13a-14a)

The Court of Appeals' decision was in full accord with principles laid down by this Court and consistent with the true nature of the type of deposits involved. The Commissioner's position would transgress these principles and ignore the character of the deposits without justification.

III. *An Arbitrary Per Se Rule Would Not Be in Accord with the Economic Substance of the Transactions or Controlling Legal Precedent.*

The Commissioner argues that an "objective and administrable approach" should be applied in determining the taxability of utility deposits. (Pet. at 14) Notably, the Commissioner seeks to couple a desire for administrative convenience with a *per se* test that would resolve all cases in the government's favor. The Commissioner would flatly declare that all deposits which primarily secure the payment of future income-related bills are themselves income. Such an arbitrary rule of thumb has never been enacted by Congress or promulgated as a regulation. As demonstrated above, it would also conflict both with the substance underlying utility deposits, especially in the case of refundable deposits collected from a limited category of noncreditworthy customers, and with the controlling principles enunciated by this Court.

Even such an arbitrary rule would not eliminate factual inquiries. It would still be necessary to examine the facts and circumstances to determine what is secured by the deposit. The Commissioner's test would simply (and erroneously) exclude from this inquiry those facts that are most indicative of the holder's rights in the deposits and thus are most crucial to resolving the issue of taxability.

The legal question in this case is whether the utility deposits constituted "gross income" under § 61(a) of the Internal Revenue Code. This is not a question which can properly be resolved by

ignoring critical facts bearing on whether the payments represent the "accession to wealth" upon which taxability is predicated. *James v. United States*, 366 U.S. 213 (1961). An evaluation of the taxpayer's rights in the deposits compared to the customer's is essential in evaluating whether the necessary increase in wealth has occurred. The Internal Revenue Code's very general definition of "gross income" makes it necessary that the courts review and weigh all the facts of a particular case to determine if a given item is taxable. Congress has not seen fit to provide an arbitrary rule of thumb for making that determination.

The Commissioner expresses conern that the Court of Appeals' approach introduces uncertainty into the treatment of customer utility deposits. (Pet. at 13). However, IPL has treated customer deposits as non-income liabilities for at least fifty years, a treatment fully in accord with generally accepted accounting principles and actually mandated by the Public Service Commission of Indiana for financial purposes. If there is now any uncertainty in this area, it arises from the government's novel and unprecedented *per se* rule, not from IPL's long-standing and consistent treatment or the generally applicable rules for determining gross income.

CONCLUSION

IPL's case involves different facts from those considered by the Eleventh Circuit in *City Gas*, and the legal analysis applied by the Eleventh Circuit is not inconsistent with the analysis of the Court of Appeals in this case. Thus, *City Gas* presents no irreconcilable conflict with the Court of Appeals' decision. In

any event the Court of Appeals' decision was correct and clearly consistent with governing principles of this Court. Therefore, review of that decision by this Court is not warranted.

The Petition for a writ of certiorari should be denied.

Respectfully submitted,

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REPLY

BRIEF

No. 88-1319

Supreme Court, U.S.
FILED
APR 17 1989
JOSEPH F. SPANIOL, JR.

In the Supreme Court of the United States

OCTOBER TERM, 1988

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

INDIANAPOLIS POWER & LIGHT COMPANY

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

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In the Supreme Court of the United States

OCTOBER TERM, 1988

No. 88-1319

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

INDIANAPOLIS POWER & LIGHT COMPANY

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

Respondent contends that the decision below does not warrant review by this Court because there is no "irreconcilable conflict" (Br. in Opp. 5) between this case and *City Gas Co.* v. *Commissioner*, 689 F.2d 943 (11th Cir. 1982). Respondent maintains that, because of "factual distinctions" (Br. in Opp. 5) between the two cases, the apparently contradictory results reached by the courts of appeals are in fact consistent. This contention is completely without merit, and, indeed, an almost identical contention has already been rejected by the Tax Court. Rather, as we maintained in the petition, the legal standards applied by the Seventh Circuit and the Eleventh Circuit to the question presented here are in direct conflict. Unless this Court grants certiorari, similarly situated taxpayers will receive

different tax treatment on this significant issue depending upon the circuit in which they are located.

As we explained in the petition (at 10-11), the legal principles relied upon by the Eleventh Circuit are flatly inconsistent with those adopted by the court below. The Eleventh Circuit held in *City Gas* that a deposit intended to secure the payment of future income must be treated as a prepayment of income; by contrast, a security deposit is not a prepayment of income if it is paid to secure the performance of nonincome-producing covenants. See 689 F.2d at 946, 948. The court below rejected this dichotomy and held that a deposit intended as security—whether for an income item or a nonincome item—should not be treated as income upon receipt (see Pet. App. 9a, 11a, 16a). Moreover, the court below found that the payment of interest on the deposit is an extremely strong indicator that it should not be treated as income upon receipt (Pet. App. 14a-15a, 17a n.12), whereas the Eleventh Circuit stated that the payment of interest is of little significance in this context (see 689 F.2d at 948 n.7). Indeed, both the court below (see Pet. App. 11a, 15a n.11, 18a n.13) and the Tax Court (*id.* at 33a-34a) recognized that it was necessary to reject the *City Gas* analysis in order to rule for respondent.

Respondent argues that the result below and the result in *City Gas* are reconcilable because of the "[m]ajor factual distinctions" (Br. in Opp. 5) between the two cases. Respondents identify two distinctions—(1) the deposits in *City Gas* were collected from all new customers, whereas the deposits in this case were collected only from customers whose creditworthiness was questioned; and (2) the deposits in *City Gas* were held until the customer terminated service and were then applied against final bills, whereas in this case the deposits were sometimes refunded

prior to termination of service. See also Amicus Br. 1-3.[1] These differences are not material to the analysis in *City Gas,* which turns on whether the deposit was intended to secure the payment of future income, and therefore there is no basis for suggesting that the Eleventh Circuit might have decided *City Gas* differently if the facts had been like those of the instant case in these two respects.

Indeed, as we noted in the petition (at 6 n.4, 11), the Tax Court has already rejected an almost identical effort to distinguish *City Gas*, finding in a case appealable to the Eleventh Circuit that the factual differences identified by respondent are not material. *Gas Light Co.* v. *Commissioner*, 55 T.C.M. (P-H) ¶ 86,118 (1986), involved the tax treatment of customer deposits made to a utility that provided natural gas to both commercial and residential customers in the Columbus, Georgia, area. Because the case was appealable to the Eleventh Circuit, the parties did not dispute that the Tax Court was bound to follow *City Gas* (55 T.C.M. (P-H) at 489). The taxpayer argued, however, that its case was factually distinguishable from *City Gas* because it required deposits only from customers whose creditworthiness was not established, not from all customers, and because in some cases the deposits were refunded before termination of service (see 55 T.C.M. (P-H) at 487, 489). These are precisely the same factual distinctions upon which respondent relies. The Tax Court, however, found that "[t]hese distinctions do not make a

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[1] Respondent also notes (Br. in Opp. 5) that two of the three companies involved in the *City Gas* case did not pay interest when they refunded deposits, but this observation is manifestly irrelevant. The court of appeals in *City Gas* found that all of the companies—including the one that paid interest—were required to treat their deposit receipts as prepayment of income. Indeed, the Eleventh Circuit specifically addressed the question of interest, finding that it is of little importance in this context (689 F.2d at 948 n.7).

difference" (*id.* at 490) because they do not suggest that "the primary purpose of the customer deposits is as security against property damage or for performance of nonincome-producing covenants" (*ibid.*). Accordingly, the Tax Court held that *City Gas* required the deposits to be treated as advance payments of income (*ibid.*).[2] Thus, the Tax Court's own decisions confirm that there is a direct conflict between the Seventh Circuit and the Eleventh Circuit, requiring the Tax Court to treat similarly situated taxpayers differently. Hence, a decision by this Court is necessary if there is to be a uniform nationwide rule of decision on the question presented in this case.

For the foregoing reasons, and those stated in the petition, the petition for a writ of certiorari should be granted.

Respectfully submitted.

WILLIAM C. BRYSON
Acting Solicitor General

APRIL 1989

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[2] The Tax Court has noted subsequently that it regards the *Gas Light* case as of little precedential value for cases not appealable to the Eleventh Circuit because the decision there was reached only under compulsion of the *City Gas* precedent, which the Tax Court rejected in its decision in the instant case. See *American Telephone & Telegraph Co.* v. *Commissioner*, Tax Ct. Mem. Dec. (P-H) ¶ 88,035, at 209 & n.6 (Feb. 3, 1988).

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AMICUS CURIAE

BRIEF

No. 88-1319

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1988

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

INDIANAPOLIS POWER & LIGHT COMPANY,
Respondent.

BRIEF AMICUS CURIAE ON BEHALF OF

American Information Technologies Corporation
Bell Atlantic Corporation
BellSouth Corporation
NYNEX Corporation
Pacific Telesis Group
Southwestern Bell Corporation
U S WEST, Inc.
American Telephone and Telegraph Company

In Support of Brief in Opposition to Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

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STATEMENT OF INTEREST OF *AMICUS CURIAE*

Amicus curiae American Telephone and Telegraph Company and certain of its former operating subsidiaries currently have pending before the United States Tax Court a case involving the identical issue presented in the instant proceeding. *American Telephone and Telegraph Co. and Consolidated Subsidiaries* v. *Commissioner*, Tax Court Docket No. 2737-89 (filed February 9, 1989). Approximately $100 million in tax deficiencies is involved. *Amicus curiae* American Information Technologies Corporation, Bell Atlantic Corporation, BellSouth Corporation, NYNEX Corporation, Pacific Telesis Group, Southwestern Bell Corporation, and U S WEST, Inc. are the current parent corporations of the former operating subsidiaries of American Telephone and Telegraph Company involved in the pending Tax Court case.

The written consents of the parties in the instant case to the filing of this brief *amicus curiae* have been submitted separately.

ARGUMENT

Amicus curiae supports respondent's opposition to certiorari for the following reasons:

1. Petitioner's contention that the decision of the Seventh Circuit below "squarely conflicts" with the decision of the Eleventh Circuit in *City Gas Co.* v. *Commissioner*, 689 F.2d 943 (1982), is erroneous.

City Gas involved deposits that were collected pursuant to tariffs and practices in effect during the 1960's. Deposits were collected from every new gas customer, were retained by the utility throughout the entire period during which service was rendered

(which could be many years), and were applied (without the payment of interest by two of the three taxpayers involved) against the customer's final bill when service was ultimately terminated. On the facts presented, such deposits were held by the Eleventh Circuit to constitute "advance payments" for gas service that were taxable to the utility when received.

Here, by contrast, the deposits (collected during 1974 through 1977) were obtained from only a small percentage of customers (those considered noncreditworthy), were held only for the limited number of months deemed necessary to establish the customer's creditworthiness, and were then promptly refunded with interest. Such deposits were held by the Seventh Circuit to constitute true "security deposits" that were not taxable on receipt.

Whatever the result ought to be in a *City-Gas*-type case, *i.e.*, where deposits are collected from *all* new customers and are held throughout the *entire* service period for application against *final* bills, *City Gas* and the decision below are quite clearly distinguishable, and therefore not in conflict on their respective facts.

Nor is there a conflict with respect to the legal test applied by the two courts. While the Eleventh Circuit in *City Gas* analyzed the case before it in terms of a dichotomy between (a) deposits, the primary purpose of which was to act as a prepayment for goods or services, and (b) deposits, the primary purpose of which was to secure the performance of nonincome-producing covenants, that court also clearly stated that in the final analysis, the proper inquiry was to determine the primary purpose of the deposits "under all the circumstances." Indeed, the Eleventh Circuit recognized (in footnote 7 of its opinion) that

the dichotomy it articulated might well be too restrictive with respect to deposits made "under other circumstances." (689 F.2d at 948, n.7).

In its decision below, the Seventh Circuit adopted and applied the same basic "primary purpose" test "based on all the facts and circumstances." Since the facts and circumstances in the two cases are quite different (creditworthiness deposits v. universal full-term deposits), it is not surprising that the Seventh Circuit found the deposits before it to have a primary purpose other than either of those specifically enumerated by the Eleventh Circuit. Both courts clearly applied the same basic test, and merely reached contrary results on very different facts. The cases do not stand in conflict with each other on principles of law any more than they do on matters of fact.

2. Petitioner contends that the issue here presented is one of "considerable administrative importance" involving "considerable revenue." Petitioner refers to an IRS estimate of more than 150 pending cases, involving more than $300 million in potential tax liabilities, in which the tax treatment of customer deposits is at issue. (Pet. 15) Nowhere, however, does petitioner acknowledge the myriad of factual differences that may be presented by such cases.

Petitioner also makes reference (Pet. 15) to an earlier case involving *amicus curiae*, in which $100 million in tax deficiencies was asserted. *American Telephone and Telegraph Co. and Consolidated Subsidiaries* v. *Commissioner*, 55 T.C.M. 16 (1988), *appeal dismissed* (2d Cir., Oct. 4, 1988) ("AT&T-I").

AT&T-I, which involved creditworthiness deposits collected by what was then the Bell Telephone Sys-

tem, dealt with the taxable years 1976 and 1977. On facts very similar to those present in the instant case, AT&T-I was decided by the Tax Court in favor of *amicus curiae*, largely on the basis of the Tax Court's own prior analysis and decision in the instant case. AT&T-I was not the subject of a timely appeal by the Commissioner.

As noted above, a second case involving such deposits has now been instituted against *amicus curiae* for the taxable year 1978. Again, $100 million in tax deficiencies has been asserted, attributable to deposits collected in 1978 and prior years. The case thus by itself represents one-third of the total amount of taxes claimed by petitioner to be at issue generally. *American Telephone and Telegraph Co. and Consolidated Subsidiaries* v. *Commissioner*, Tax Court Docket No. 2737-89 (filed February 9, 1989) ("AT&T-II").

Assuming, as expected, that the Tax Court again finds in favor of *amicus curiae*, either on the merits or on grounds of estoppel or both, that case will be appealable by the Commissioner to the Second Circuit. If then decided in the Commissioner's favor on the merits, the decision of the Second Circuit would be in square conflict with the decision of the Seventh Circuit in the instant case.

At least two other cases involving creditworthiness deposits very similar to those here involved are also pending in the Tax Court. *The Southern New England Telephone Co.* v. *Commissioner*, Tax Court Docket No. 22171-88 (filed Aug. 26, 1988); *United Telecommunications Inc. and Subsidiaries* v. *Commissioner*, Tax Court Docket No. 38464-86 (filed Sept. 25, 1986). Neither case would be appealable to the Seventh or Eleventh Circuit.

Given the fact that there is as yet no direct conflict in the Circuits involving creditworthiness deposits, and cases presenting the potential for such a conflict are now pending in the lower courts, *amicus curiae* respectfully suggests it is premature for this Court to become engaged in the utility deposit controversy at this time.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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PETITIONER'S

BRIEF

Supreme Court, U.S.
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No. 88-1319

In the Supreme Court of the United States

OCTOBER TERM, 1988

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

INDIANAPOLIS POWER & LIGHT COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE PETITIONER

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QUESTION PRESENTED

Whether customer deposits required by a public utility to insure the payment of future bills are income to the utility upon receipt.

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In the Supreme Court of the United States

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COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

INDIANAPOLIS POWER & LIGHT COMPANY

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-18a) is reported at 857 F.2d 1162. The opinion of the Tax Court (Pet. App. 19a-39a) is reported at 88 T.C. 964.

JURISDICTION

The judgment of the court of appeals (Pet. App. 40a) was entered on September 20, 1988. On December 12, 1988, Justice Stevens extended the time within which to petition for a writ of certiorari to and including February 8, 1989. The petition was filed on February 7, 1989, and was granted on April 24, 1989. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTORY PROVISIONS INVOLVED

Section 61(a) of the Internal Revenue Code (26 U.S.C.) provides in pertinent part:

> **General Definition**
>
> Except as otherwise provided in this subtitle, gross income means all income from whatever source derived * * *.

Section 451(a) of the Internal Revenue Code (26 U.S.C.) provides:

> **General Rule**
>
> The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

STATEMENT

1. Respondent is an Indiana corporation engaged in the business of generating, distributing, and selling electricity and steam in Indianapolis, Indiana, and its vicinity. It is a public utility, subject to regulation by the Public Service Commission of Indiana (PSCI). As part of its customary method of conducting business during the years in issue, 1974-1977, respondent required approximately five percent of its commercial and residential customers to pay a deposit as a precondition to receiving service. The customers required to pay deposits were chosen based upon their creditworthiness, and the stated purpose of the deposits was "to insure prompt payment" of the customers' future utility bills. Pet. App. 2a.

The details of respondent's deposit program changed during the years at issue because of amendments made by PSCI to its rules of service on March 10, 1976. Prior to that time, respondent determined on an ad hoc basis when it would require a customer deposit, based on a creditworthiness analysis made by its own employees. The amount of the required deposit ordinarily was twice the customer's estimated monthly bill. Respondent refunded these deposits prior to termination of service only if the customer specifically requested a review and demonstrated his creditworthiness. Upon termination of service, respondent refunded the deposits by means of a credit to the final bill or, if requested by the customer, by cash or check. In addition, respondent was required to pay interest at the rate of three percent per year on deposits held at least six months. This interest was payable upon return of the deposit, or annually upon demand in writing by the customer. Pet. App. 2a-3a, 21a-22a.

The PSCI amended its rules of service concerning utility customer deposits in 1976, largely in order to reduce arbitrariness in the system. Under the amended rules (see Ind. Admin. Code tit. 8, r. (8-1-2-4)-A42 (Burns Supp. 1978)), respondent was required to determine the creditworthiness of each residential applicant or existing residential customer according to objective criteria.[1] Deposits could be required of new customers only if they failed a creditworthiness test furnished by the PSCI; deposits could be required of existing customers only if they had a history of late payments. The amended rules also specified that interest would have to be paid at the rate of six percent, but only on deposits held for more than 12 months. Pet. App. 3a, 22a.

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[1] Commercial customers continued to be evaluated for creditworthiness on a case-by-case basis (Pet. App. 3a).

The amended rules of service also defined when a customer had reached a point at which his credit record was such that retention of a deposit should no longer be necessary. In compliance with those rules, respondent refunded residential customers' deposits after timely payment for a period of either nine successive months or ten out of any twelve consecutive months (provided that the two delinquent months were not consecutive), or if the customer subsequently satisfied the credit test. These refunds generally were made by cash or check, unless the customer requested that they be credited against his bill. When a customer requested termination of service, however, respondent usually applied the deposit as a credit to the customer's final bill. In the event of an involuntary termination of service, respondent used the deposit to cover any unpaid balance in the customer's account and returned any surplus to the customer. Generally, an involuntary termination of service occurred when 90 days had elapsed after a bill was sent with no payment for the charges included on that bill or a later one. Pet. App. 3a, 23a. During the years in issue, 57.7% to 69% of the amounts refunded were in the form of credits against the customer's bill (*id.* at 25a).[2]

The customer deposits received by respondent were not segregated from its other assets in any manner; they were subject to its unfettered control and were used in the ordinary course of its business. Respondent, an accrual basis taxpayer, treated the deposits on its books as current liabilities, and it did not report them on its income tax returns as gross income. When the deposits were refunded

[2] If a refundable deposit was unclaimed, it escheated to the state after seven years. During the period in issue, $1,197,629 in deposits was refunded by cash, check, or credit, and less than $9,324 in deposits escheated to the state. Pet. App. 24a-25a.

or applied against a customer's bill, respondent made appropriate accounting adjustments. Pet. App. 3a-4a, 23a.

2. On audit of respondent's returns for the years 1974 through 1977, the Commissioner issued a notice of deficiency asserting that the customer deposits should be treated as advance payments and that they constituted income upon receipt. See Rev. Rul. 72-519, 1972-2 C. B. 32. Accordingly, he determined that respondent was required to include in its income for 1975 the balance of customer deposits outstanding at the end of the year (less the amount of deposits on hand at the end of 1954), and to adjust its income for each succeeding year by the amount of the increase or decrease in deposits on hand at the end of the year.[3] Respondent filed a petition in the Tax Court seeking redetermination of the asserted deficiencies.

The Tax Court ruled in favor of respondent in a reviewed decision (Pet. App. 19a-39a). The court followed the approach that it had taken in *City Gas Co.* v. *Commissioner*, 74 T.C. 386 (1980), rev'd, 689 F.2d 943 (11th Cir. 1982), and explicitly rejected the Eleventh Circuit's holding in *City Gas* that deposits paid to insure the payment of future utility bills are income upon receipt if they

[3] This adjustment followed Rev. Rul. 72-519, *supra*, which specifies that when customer deposits are treated as advance payments, such an adjustment is one attributable to a change in method of accounting governed by the provisions of Section 481 of the Internal Revenue Code (26 U.S.C.). The amount of the adjustment in the notice of deficiency was later recomputed to reflect the parties' agreement as to the applicability of Treas. Reg. § 1.451-5, which provides that the inclusion in income of certain advance payments for inventoriable goods may be deferred for up to two years after receipt and specifies certain cost offsets. The parties then stipulated that respondent's returns should be adjusted by these recomputed amounts "should the [Tax] Court determine that the customer deposits received by [respondent] are advance payments" (Stip. para. 30).

are under the control of the utility.[4] The Tax Court concluded that, in determining whether a deposit to secure the payment of future bills is income upon receipt, it is necessary "to examine all of the facts and circumstances surrounding a deposit to evaluate the rights retained by the depositor and the rights acquired by the holder of the deposit" (Pet. App. 34a).

Under this approach, the Tax Court found that the following factors indicated that the deposits should not be treated as income: because only five percent of the customers were required to make the deposits and they were chosen on the basis of creditworthiness, the deposits were not intended as "advance payments"; the customers controlled the ultimate disposition of the deposits, in that they could obtain a refund by timely payment and could choose whether to apply the refund as an offset or to receive a check; respondent's rights in the ultimate disposition of the funds were "minimal" and did not arise unless the customer failed to pay; respondent treated the deposits on its books as the customers' property; and respondent paid interest when it refunded a deposit. Pet. App. 34a-36a. The court concluded that "the deposits were not advance payments of income but were temporarily held by the petitioner to secure payment of the bills and were not therefore includable in gross income" (*id.* at 36a).

3. The court of appeals affirmed (Pet. App. 1a-18a). Although it recognized that, "in terms of the recipient's

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[4] The Tax Court is a court of national jurisdiction and is not bound to follow a court of appeals decision that reversed the Tax Court in an earlier case. The Tax Court does follow court of appeals decisions in the circuit to which an appeal in the case at hand would lie. See *Commissioner* v. *Portland Cement Co.*, 450 U.S. 156, 164 (1981); *Golsen* v. *Commissioner*, 54 T.C. 742, 756-758 (1970), aff'd, 445 F.2d 985 (10th Cir.), cert. denied, 404 U.S. 940 (1971).

cash flow, deposits to secure income items and advance payments are essentially the same" (*id.* at 9a), the court declined to follow the Eleventh Circuit's holding in *City Gas* that a sum given primarily to secure the performance of an income producing covenant is taxed as an advance payment. Using a rental agreement as an example of an income-producing covenant, the court acknowledged that "[t]he functional similarity between an advance payment of rent and a deposit to secure the payment of rent suggests that they should be taxed similarly" (*id.* at 10a), but the court concluded that it did not necessarily follow "that a deposit to secure an income payment must always be taxed as an advance payment" (*id.* at 11a).

The court of appeals sought to explain its departure from the tax treatment suggested by this "functional similarity" by means of an analysis of the economic benefit that flows to the utility from temporary use of the customer's funds (Pet. App. 11a-17a). The court identified two principal reasons why a deposit is "valuable" to a utility: (1) as security against possible delinquency; and (2) for the ability to obtain a "return" (for example, by investment) on the utility's possession of the funds (*id.* at 13a-14a). The court dismissed the "security factor" as insignificant to the inquiry, noting that it was equally present in the case of security deposits made to insure against property damage, which undisputedly are not treated as advance payments (see *id.* at 11a n.9, 14a). With respect to the "return factor," the court posited what it described as an "extreme case" in which the utility was required to invest the deposits in a particular manner and to refund to its customers every penny of the interest earned (*id.* at 14a-16a). In that situation, the court stated that there would be no return benefit at all, only a security benefit, and "this benefit alone * * * does not constitute 'the use'

of the proceeds in a manner sufficient to justify immediate taxation of the deposit" (*id.* at 14a). Because of this "extreme case," the court concluded "that deposits to secure the payment of an income item such as rent can be a distinct category from advance payments for tax purposes" (*id.* at 16a).

Having decided that a court is not "automatically required" to regard a deposit to secure an income payment as income upon receipt, the court held that it should "retain the traditional approach of analyzing the facts and circumstances to determine whether the principal purpose of a 'deposit' is to secure future performance or to serve as an advance payment of income" (Pet. App. 16a-17a). Applying this analysis, the court held that the Tax Court's decision that the deposits in this case "served as security and were not prepayments of income is not clearly erroneous" (*id.* at 17a). The court explained that the primary factor supporting this conclusion was the payment of interest. It also found it significant that the customer (through his payment record) " 'controlled' the timing of the refund" (*ibid.* (quoting *id.* at 34a)), and that respondent did not intend that the deposits serve as prepayments (*id.* at 17a-18a).

SUMMARY OF ARGUMENT

A. It is well settled that payments made in advance for goods or services to be provided in the future are taxable as income upon receipt; the recognition of such payments as income cannot be deferred until a later year when they are earned by performance. See, *e.g.*, *American Automobile Ass'n* v. *United States*, 367 U.S. 687 (1961). Thus, it has generally been held that an advance payment of rent is taxable as income upon receipt. On the other hand, a payment to secure the performance of nonincome-

producing covenants, such as a covenant to maintain the property in good condition, is not taxable as income upon receipt. The Commissioner and the Eleventh Circuit have correctly concluded that, under this framework, a utility customer deposit to secure the payment of future bills is equivalent to an advance payment and should be taxed as income upon receipt.

B. A deposit to secure the payment of future income is not meaningfully different from an advance payment, and there is no justification for according disparate tax treatment to the two kinds of payments. As the court below recognized (Pet. App. 9a), "in terms of the recipient's cash flow, deposits to secure income items and advance payments are essentially the same." The deposit is taken into the unrestricted possession and control of the utility at the time it is received, and it serves to pay future customer bills. If the customer defaults on a payment, the deposit is used to cover the bill, and it is identical to an advance payment. If the customer does not default, the refund may be made in the form of a credit against future bills or it may be made in the form of a payment to the customer. Only in the latter event is it even superficially different from an advance payment. But the economic reality of such a refund payment is no different from applying the deposit as a credit to the customer's bill. The customer simply "buys back" the deposit through a formalistic check exchange in which he pays all his bills and then receives a check from the utility in the amount of the deposit.

The purpose and operation of both an advance payment and a deposit to secure future income are the same. The security deposit is required by the seller because he believes there is a substantial risk that future bills will not be paid. Thus, the contemplated disposition of the deposit is to ap-

ply it to a future unpaid bill; indeed, that is the sole purpose for the deposit requirement. And, as noted earlier, even if the customer does not default, the manner in which the deposit is refunded—either through a credit to the customer's account or through an exchange of checks—does not serve to remove it from the category of an advance payment. In the case of both a deposit to secure the payment of future income and an advance payment, the recipient has ensured that it will receive payment for future services by the simple act of taking the money in advance. There is no sound reason for the tax system not to treat the "security deposit" as an advance payment.

The distinction drawn by the Commissioner and the case law between a deposit to secure the payment of future income and a deposit to secure the performance of nonincome-producing covenants is a sound one. There is a significant difference between these two kinds of deposits with respect to the general income-recognition principles of our tax system. A security deposit to guarantee the performance of nonincome-producing covenants is never converted into income; it either is refunded or is used to compensate for a loss. A deposit to secure the payment of future income, on the other hand, clearly is designed to yield income, and the only issue is the timing of the recognition of that income for tax purposes. Here, there is no contention that the deposits were for a purpose other than to secure the payment of future income, and therefore they should be taxed as income upon receipt.

C. The court of appeals erroneously held that whether a deposit should be treated as an advance payment turns almost exclusively on the presence or absence of an obligation to pay interest to the customer on the deposit. But an interest obligation is not a logical guidepost for distinguishing between an advance payment and a deposit

to secure the payment of future income. It is simply a means of accounting for the time value of money in a given transaction, which is equally relevant for an advance payment (where it often takes the form of a discount to the customer) as for a deposit to secure future income. The presence of an interest obligation is particularly insignificant in this case, where the terms of the obligation were such that no interest at all was paid on many of the deposits. Thus, the interest obligation clearly did not substantially interfere with respondent's control over the deposited funds or with its ability to earn a considerable investment return on its use of them. Here, the payment of interest reflects an obligation to compensate customers for the loss of the use of their money that the utility has required to be deposited in advance; it is plainly not inconsistent with taxation of the deposited funds as income upon receipt.

D. The Tax Court's "facts and circumstances" test is erroneous and unworkable because it directs the courts to distinguish between different deposit arrangements on the basis of factual details that are largely irrelevant to the question of the correct tax treatment. More fundamentally, the approaches of both courts below are flawed because they direct the courts to make a factbound determination of whether a particular payment is intended as a deposit to secure the payment of future income or as an advance payment of that future income, even though the "functional similarity" (Pet. App. 10a) between these two kinds of payments is such that they are not meaningfully different.

ARGUMENT

A DEPOSIT TO SECURE THE PAYMENT OF FUTURE INCOME IS ESSENTIALLY INDISTINGUISHABLE FROM AN ADVANCE PAYMENT FOR FUTURE GOODS OR SERVICES AND THEREFORE IS TAXABLE AS INCOME UPON RECEIPT

A. An Advance Payment For Goods Or Services To Be Provided In The Future Is Taxable As Income Upon Receipt

It is well settled that payment made in advance for goods or services to be provided in the future is taxable as income in the year of receipt. See *Schlude* v. *Commissioner*, 372 U.S. 128 (1963); *American Automobile Ass'n* v. *United States*, 367 U.S. 687 (1961); *Automobile Club* v. *Commissioner*, 353 U.S. 180 (1957). This is so even though the income is not truly earned by the recipient until the goods or services are provided, and, indeed, even though the recipient presumably would be obligated to refund the advance payment if it defaulted on its promise to provide the goods or services. Moreover, the advance payment is taxable in the year of receipt even though generally accepted principles of financial accounting would not include it in income until earned by performance. As this Court explained, the deferral of the advance payment for accounting purposes "doubtless presents a rather accurate image of the total financial structure, but fails to respect the criteria of annual tax accounting and may be rejected by the Commissioner" (*American Automobile Ass'n* v. *United States*, 367 U.S. at 692). See also *Schlude* v. *Commissioner*, 372 U.S. at 132. Thus, "the general rule for income tax accounting purposes remains that a taxpayer may not defer the inclusion in income of prepayment received during the taxable year for the furnishing of goods and services in later years." Stanger, Vander Kam & Polifka, *Prepaid Income and Estimated Expenses: Financial Accounting Versus Tax Accounting Dichotomy*, 33 Tax Law. 403, 416 (1980).[5]

A series of early cases in the lower courts delineated the application of this general principle to monies paid "up front" as part of a rental agreement. Even prior to this Court's decisions in the area, it was well settled in the lower courts that an advance payment of rent was taxable as income upon receipt. See, *e.g.*, *Astor Holding Co.* v. *Commissioner*, 135 F.2d 47 (5th Cir. 1943); *Mantell* v. *Commissioner*, 17 T.C. 1143, 1147-1148 (1952). Even where the payment was referred to as a "deposit" and where it was possible that it would be applied for some purpose other than the payment of rent, the courts recognized that the payment should be taxable as income upon receipt so long as the payment's primary purpose was as an advance payment of rent. See *Gilken Corp.* v. *Commissioner*, 176 F.2d 141 (6th Cir. 1949); *Hirsch Improvement Co.* v. *Commissioner*, 143 F.2d 912 (2d Cir. 1944). On the other hand, the courts also held that payments made for the purpose of securing the performance of covenants under the lease, such as a covenant to maintain the property in good condition, were not taxable as income upon receipt, even though the money might be applied to the final rent payment if there was no occasion for applying it otherwise. See *Clinton Hotel Realty Corp.* v. *Commissioner*, 128 F.2d 968 (5th Cir. 1942); *Warren Serv-*

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[5] This rule governing the tax treatment of advance payments accords with the "claim of right doctrine," set forth by the Court in *North American Oil Consolidated* v. *Burnet*, 286 U.S. 417, 424 (1932) as follows: "If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent." See *Automobile Club* v. *Commissioner*, 353 U.S. at 188-189.

ice Corp. v. *Commissioner*, 110 F.2d 723 (2d Cir. 1940); *Mantell* v. *Commissioner, supra.*[6] The general rule that emerged from these decisions was cogently summarized by the Tax Court as follows (*J. & E. Enterprises, Inc.* v. *Commissioner,* 36 T.C.M. (P-H) ¶ 67,191, at 1033 (1967)):

> If a sum is received by a lessor at the beginning of a lease, is subject to his unfettered control, and is to be applied as rent for a subsequent period during the term of the lease, such sum is income in the year of receipt even though in certain circumstances a refund thereof may be required. * * * If, on the other hand, a sum is deposited to secure the lessee's performance under a lease, and is to be returned at the expiration thereof, it is not taxable income even though the fund is deposited with the lessor instead of in escrow and the lessor has temporary use of the money. * * * In this situation the acknowledged liability of the lessor to account for the deposited sum on the lessee's performance of the lease covenants prevents the sum from being taxable in the year of receipt.

In 1972, the Commissioner applied this analytical framework to the issue of customer deposits required by utilities as a condition of providing service. Rev. Rul. 72-519, 1972-2 C.B. 32. The situation described in the Revenue Ruling was that of a water company that required each new customer to make a deposit in an amount exceeding one month's bill. The stated purpose of the deposit was to guarantee the payment of a customer's future bills

[6] The court explained in *Clinton* that there were "many things to which [the payment] might become applicable besides the tenth year's rent" and the lease reflected the parties' "intention was that it stand as a security for the lessee's performance in all respects of the lease." 128 F.2d at 970.

for water supplied by the company, but the company had unrestricted use of the deposited funds. When the account was terminated, the deposit was applied by the water company against any unpaid balance in the customer's account, and the difference was refunded. The water company paid annual interest on the deposit. The ruling stated the governing principle as follows (*id.* at 33): "when the purpose of the deposit is to guarantee the customer's payment of amounts owed to the creditor, such a deposit is treated as an advance payment, but when the purpose of the deposit is to secure a property interest of the taxpayer the deposit is regarded as a true security deposit" that is not recognized as income upon receipt. The ruling then concluded that the customer deposit paid to the water company was essentially an advance payment for water because it was "received as security for the payment of amounts owed to [the company] for water and is to be applied against the customer's ending balance when the contract is terminated." *Ibid.* The ruling specifically noted that "[t]he fact that [the company] pays annual interest on the 'deposit' does not outweigh its primary characteristics as an advance payment." *Ibid.*[7]

The Eleventh Circuit in *City Gas Co.* v. *Commissioner*, 689 F.2d 943 (1982), approved the Commissioner's ap-

[7] The ruling contrasted the situation of the utility customer deposit with the situation of a fuel supplier who delivers fuel to service stations who store it in their tanks. The fuel, however, remains the property of the supplier until it passes through a meter when it is being delivered to a motorist. The supplier requires the service station operator to make a deposit to protect the supplier's title and interest in the fuel stored on the service station's premises. In that situation, the ruling stated that the purpose of the deposit is to protect the supplier's property interest in the fuel prior to its sale, not to secure payment of amounts due from the service station for purchased fuel. Accordingly, the ruling concluded that the deposit is not an advance payment.

proach to the question of including utility customer deposits in income. The court stated that the line of rental cases stood for the proposition that if "the deposit more closely resembles a prepayment for goods and services rather than security for property or performance of nonincome-producing covenants, then the payment will be taxable" upon receipt (*id.* at 947). And the court stated that a deposit intended to secure the payment of future income, and hence "intended to be applied against income items" (*id.* at 948 n.7), is equivalent to a prepayment for goods or services (*id.* at 948-949). The court concluded by observing that the fact that "the customer might pay the final bill without regard to the deposit, thus requiring a refund," does not alter the essential character of such a deposit as a prepayment of income (*id.* at 950).

B. Deposits To Secure The Payment Of Future Income, Such As The Utility Customer Deposits Here, Are Equivalent To Advance Payments And Should Be Taxed Accordingly

The position taken by the Commissioner in Rev. Rul. 72-519 and approved by the Eleventh Circuit in *City Gas*—namely, that a deposit to secure payments that will be due in the future after goods or services are provided is equivalent to an advance payment—properly reflects both the purpose and the economic effect of such a deposit. Indeed, the logic of the Commissioner's approach was explicitly recognized by the court of appeals below. The court acknowledged what it termed a "functional similarity" (Pet. App. 10a) between an advance payment for goods or services and a deposit to secure the payment of future income, specifically finding that "in terms of the recipient's cash flow, deposits to secure income items and advance payments are essentially the same" (*id.* at 9a). The court elaborated on this observation by considering the

example of a rental agreement where one month's rent is paid "up front," either as an advance payment or as a rental payment security deposit. In both cases, if "the lessee does not default, the lessor receives the sum up front and has discretion over the use of the money during the lease term" (*ibid.*). In the case of the advance payment, the lessee does not pay the last month's rent. In the case of the security deposit, the lessee may pay the last month's rent, but at the same time his deposit in the amount of one month's rent is returned to him. As the court of appeals recognized (*id.* at 10a), this is just an economically meaningless "exchange of checks"; indeed, for convenience, the lessor may simply elect to have the deposit applied to the last month's rent, thereby eliminating even this superficial difference.[8] And, as the court further acknowledged, "[t]he situations are also similar if the lessee defaults" (*ibid.*). Whether the original payment is termed an advance payment or a security deposit, the lessor is entitled to apply it to the payment on which the lessee defaulted, and he is still entitled to the remaining payments under the lease (*ibid.*).

The court of appeals' recognition of a "functional similarity" (Pet. App. 10a) between an advance payment and a deposit to secure the payment of future income actually understates the case; in fact, these two terms describe payments that are basically identical. From the perspective of both the payor and the recipient, these two

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[8] This exchange of checks is similarly meaningless for tax purposes. If he has previously treated the deposit as income, the lessor is entitled to a deduction for its return (as well as for any interest that may be paid). If the deposit is instead applied to the last rent payable, there is of course no deduction for its return, but there is no corresponding payment by the lessee that yields income. Thus, the "return of the deposit" through an exchange of checks simply yields an offsetting addition to both income and deductions in the same amount.

kinds of payments are intended to serve the same function and to operate in essentially the same manner. There is no justification for according them different tax treatment.

Whenever a vendor sells goods or services to a purchaser, the issue of the timing of payment arises. Each party's natural preference is to receive its end of the bargain first. In the terminology of the court of appeals, this promotes both a "security" interest in knowing that the other side has already adhered to its agreement, and a "return" interest in that inflation and investment opportunity generally make it advantageous for a person to receive money or property sooner, rather than later—*i.e.*, the time value of money. When goods are purchased in a retail store, there is often a simultaneous exchange. In other contexts, however, especially where there is a continuing relationship between the parties, the exchange may not be simultaneous; one party will perform its end of the bargain with the expectation that the other will satisfy its reciprocal obligation as agreed. And the extent to which a party will agree to deviate from the model of simultaneous exchange, of course, reflects in large part the degree to which it trusts the other party to fulfill its obligations.

A vendor that trusts a customer to pay its debts ordinarily will be amenable to furnishing the goods or services in question along with a bill for future payment. If the vendor does not trust the customer to pay, however, it will not want to part with its product unless it is paid first. If simultaneous exchange is impractical, the vendor will insist on payment in advance from that customer. This advance payment alleviates the vendor's "security" concern—*i.e.*, the fear that it will not be paid for the goods or services it supplies. Although the purpose of this advance payment is to give the vendor "security" by protecting him against default, it is well settled that the payment is taxable as income upon receipt (see pages 12-14, *supra*).

An advance payment that is labelled a "security deposit" because it is intended to secure the future payment of bills for goods or services, such as the utility customer deposits in this case, is not meaningfully different from an ordinary advance payment collected with the understanding that it will be applied to pay for goods or services to be delivered in the future. In both cases, the taxpayer has insured that it will receive payment for these goods or services by the simple act of taking the money in advance. The superficial difference is that the "security deposit" is designed to be refunded if all payments are made in a timely fashion, whereas the ordinary "advance payment" is designed to be applied to some future debt. Given the fungibility of cash, however, this difference is meaningless in economic terms, and it should be similarly meaningless for tax purposes.

First, the possibility of refund is not unique to the "security deposit." Any advance payment is made on the assumption that the goods or services covered by the payment will be provided to the purchaser; if payment has been made and the seller fails to provide the services, the advance payment will be refunded. When a security deposit is refunded, it is for the same reason—*i.e.*, to satisfy the requirement that a payment ultimately be matched to a commensurate provision of services. Because of the customer's complete payment record, there remains no outstanding provision of goods or services for which payment is due, and therefore the deposited amount should be returned.

Second, even when a cash security deposit ultimately is refunded upon full payment of a customer's debt, that does not destroy the deposit's essential character as an advance payment. Economically, the situation is the same as if the deposit had been applied to pay the customer's outstanding bill. In both cases, the seller has had

unrestricted use of the deposited funds and the purchaser has been deprived of the funds for some period of time prior to the provision of the goods or services paid for by those funds. The only difference is that in one case the deposited funds are applied directly by the seller to pay for the services in question; in the other case, the customer directly pays for the services and then has the amount of the deposit returned by the seller. This variation is purely a matter of form; the "return of the deposit" simply involves an exchange of checks that makes no practical difference and should not yield different tax treatment. See, *e.g.*, Pet. App. 10a; *August* v. *Commissioner*, 17 T.C. 1165 (1952).[9] In essence, the customer "buys back" the advance deposit by making payment in the same amount for services provided. It therefore should make no difference in the tax treatment of deposits to secure future payments for goods or services whether the deposit will be applied to pay for the final period of service, or instead will be fully refunded either upon complete payment of the final bill or upon a determination that the customer is sufficiently reliable that retention of a deposit is no longer deemed necessary to guarantee future payment. See generally Burke & Friel, *Tax-Free Security: Reflections on* Indianapolis Power & Light, 12 Rev. Tax'n Individuals 157,

[9] The "exchange of checks" in the utility deposit context is not as tidy as it is in a situation, such as a lease, where the amount due for each time period is fixed in advance. That uncertainty concerning the charge for each month, however, does not alter the fact that there is no practical difference between return of the deposit after full payment and direct application of the deposit to satisfy the bill for services. See *City Gas Co.* v. *Commissioner*, 689 F.2d at 949; *Van Wagoner* v. *United States*, 368 F.2d 95 (5th Cir. 1966) (deposit premiums designed to secure the payment of future insurance premiums that varied according to actual usage of the insured machinery).

167-168 (1988) ("There seems little substantive difference between a deposit that may be applied to reduce future rents and a deposit that must be returned once the future rent has been paid.").

Moreover, the practical congruence of an ordinary advance payment and a deposit to secure the payment of income items, such as a utility customer deposit, is not merely some type of economic coincidence; rather, it is inherent in the rationale for requiring such a security deposit. Regardless of the label that is attached, from the outset of the transaction the customer's deposit payment is intended by the recipient to be applied as a payment for goods or services. That is the sole purpose of the deposit requirement. The seller believes that there is a substantial risk that the customer will default in payment after service is provided. Therefore, it collects the security deposit in advance to apply to the bill for the period in which the customer defaults. Thus, the contemplation and intention of the taxpayer is that the deposit will function as an advance payment of a future bill. Indeed, on the facts of this case, in every year at issue the majority of the "security deposits" were not refunded, but were applied as a credit to the customer's bill for future services, and hence they undeniably operated as an ordinary advance payment. See Pet. App. 24a. Only if the seller's expectation is not fulfilled and the customer turns out to be reliable can the deposit fail to be applied to a payment for goods or services. And even in that case, the deposit may be applied for that purpose or, if it is returned, it is in conjunction with a payment by the customer for services so that the practical effect of the deposit remains as an advance payment. Thus, treating the deposit as something other than an advance payment fails to recognize its basic purpose and effect.

The economic reality of the "deposit" to secure future income has been cogently summarized in a comment criti-

cizing the Tax Court's decision in this case: "It is, in theory, perfectly appropriate to tax on receipt a deposit that the taxpayer is permitted to apply to future rent, utility charges, or any other income item, regardless of whether such application is mandatory, at the taxpayer's option, or is permitted only in the event of future nonpayment by the other party. The deposit, in all these instances, provides a clear economic benefit in the sense that, to the extent of the deposit, 'future' income has been assured." Burke & Friel, *supra*, 12 Rev. Tax'n Individuals at 173-174. In short, whether the deposit must be applied to future rent obligations or whether it is refundable through an exchange of checks in which the customer directly pays the rent obligations, the deposit operates as an advance payment and should be taxed accordingly.

Contrary to the court of appeals' view (Pet. App. 11a n.9), the distinction drawn in Rev. Rul. 72-519 between a deposit to secure the payment of future income and a deposit to secure the performance of nonincome-producing covenants is a sound one. There is a significant difference between these two kinds of deposits with respect to the general income-recognition principles of our tax system. As we have explained, a deposit to secure the future payment of funds that will become income is essentially the same as an advance payment of income. That is not true of a deposit to secure the performance of nonincome-producing covenants, such as to protect the owner against property damage, because the deposit is never converted into income. If there is no property damage, the deposit is returned to the renter. If there is property damage, the deposited funds are used to repair the property, which does not yield income to the holder of the deposit either (unless the amount retained exceeds the repair costs).

Thus, the deposit to secure against property damage or the performance of other nonincome-producing covenants is akin to a loan, which does not generate income. The critical difference is that the consideration for an advance payment for goods or services (even if termed a security deposit) is "a commitment to render income-producing services in the future"; therefore, "an advance payment for income-producing services to be rendered in the future *must* result in income either at the time of receipt, the time of performance, or both." J. Sneed, *The Configurations of Gross Income* 50 (1967). By contrast, the loan or the deposit to secure against property damage need never give rise to income, and therefore it is not appropriate to tax such a deposit or loan as income upon receipt.[10]

There is no doubt that the customer deposits in this case must be taxed as income upon receipt under the approach of the Revenue Ruling and the Eleventh Circuit in *City Gas*. It has never been suggested that the deposits were in-

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[10] The court of appeals noted that the distinction between deposits to secure the performance of nonincome-producing covenants and deposits to secure the payment of future income is blurred because, as a practical matter, the former type of deposit also may be applied in the event of a rent default. See Pet. App. 12a n.9. The correct treatment of such a "dual purpose" security deposit has been explored in the rental cases, and the Revenue Ruling and the Eleventh Circuit in *City Gas* have adopted the rule set forth in those cases – namely, the court will look to the primary purpose of the payment, and a payment that is primarily intended to secure the performance of nonincome-producing covenants will not be treated as an advance payment solely because it might be applied as a rent payment (or a payment for goods and services) if there is no prior occasion for applying the deposit. See 689 F.2d at 946; *Gilken Corp.* v. *Commissioner*, *supra*; *Hirsch Improvement Co.* v. *Commissioner*, *supra*; *Montell* v. *Commissioner*, *supra*. In this case, there is no question of such a dual purpose deposit; it is clear that the only purpose for the deposits required by respondent was to secure the payment of future income.

tended to secure the performance of any nonincome-producing covenants. Their sole purpose was to secure the payment of future utility bills by getting the money "up front." Since respondent had unrestricted use of the deposited funds, they should be regarded as advance payments and taxed as such.

C. The Court Of Appeals Incorrectly Rejected The Approach Of The Revenue Ruling In Favor Of An Undue Emphasis On The Existence Of An Interest Obligation

The court of appeals provided no adequate explanation for its departure from the logical tax consequences of the acknowledged similarity between advance payments and deposits to secure the payment of future income. The court's approach was to seek to discredit the absolute statement that such a deposit "must *always* be taxed as an advance payment" (Pet. App. 11a (emphasis added)). The court did this by positing what it described as "an extreme case" (*id.* at 16a). In the court's hypothetical, the utility is required to keep the deposited funds in its corporate savings account and to repay the deposits with the same interest received by the utility (see *id.* at 14a). The court concluded that such deposits are not advance payments because the utility can receive no benefit from the payment other than the "security" against nonpayment; any return from the utility's use of the money must be forwarded to the customer. From its determination that, because of this "extreme case," deposits to secure income should not *always* be taxed as advance payments, the court of appeals leaped to the conclusion that the functional similarity between the two concepts could be ignored. Instead, the court stated that the tax treatment of the deposit should turn on an inquiry into the facts and circumstances of each individual case, and it held that the payment of interest on the deposit is a particularly significant – indeed, almost

dispositive – factor demonstrating that the deposit should not be taxed as an advance payment. *Id.* at 15a-17a & nn. 11-12.

The court of appeals' analysis is flawed in several respects. First, the hypothetical posited by the court is not merely an "extreme case"; it is a completely different case that has no bearing at all on the treatment of the typical utility deposit, such as the ones paid to respondent. In the court of appeals' hypothetical, the use of the deposited funds was severely restricted because the utility was required to invest the funds in a specified manner and to turn over all of the proceeds of that investment to the depositor. In effect, the funds were escrowed, and, as a practical matter, were not within the control of the utility at all. The conclusion that such funds should not be taxed as income sheds no light upon the issue in this case – whether utility customer deposits over which the utility exercises unfettered control (see Pet. App. 23a) and which can generate a significant investment return to the utility should be treated as advance payments. Moreover, even if the court of appeals is correct that some "extreme case" would warrant deviation from a rule "automatically requir[ing]" (*id.* at 16a) a deposit to secure future income to be treated as an advance payment, that hardly justifies the court's leap to a rule that completely ignores the acknowledged similarity in less extreme circumstances between the two types of payments and, indeed, that in most cases would result in treating the "security deposit" differently from the economically equivalent advance payment.

The standard established by the court of appeals for determining when a security deposit must be treated as an advance payment is wholly unsatisfactory. The court characterized its decision as "retain[ing] the traditional ap-

proach of analyzing the facts and circumstances" (Pet. App. 16a), with the payment of interest "a very important factor" (*id.* at 17a n.12). Upon closer examination, however, the court's opinion strongly suggests its view that the payment of anything more than a nominal amount of interest automatically forecloses treatment of the deposit as an advance payment. The court stated that the reason that an advance payment is taxable as income upon receipt is "because typically the entire return generated during the interim will accrue to the recipient without an offsetting interest payment" (*id.* at 15a). And the court found that the "presence or absence of the payment of interest substantially reconciles the line of cases addressing the taxability of customer deposits" (*id.* at 15a n.11).[11] See B. Bittker, *Federal Taxation of Income, Estates and Gifts* ¶ 105.3.4, at S105-37 (Supp. 1989) (court of appeals decision in this case "makes presence or absence of interest determinative"). Thus, the court of appeals' opinion strongly suggests a rule that a taxpayer is required to include an advance payment in income only when the taxpayer can obtain a full investment return of its own on that payment during the time it holds it.

In its application of a "facts and circumstances" analysis to the facts here, the court of appeals relied almost exclusively on the mere existence of an interest obligation, without making any analysis of the extent to which that obligation restricted respondent's ability to use the

[11] The court of appeals also stated that once a reasonable rate of interest is paid on the deposit, the value of the deposit then relates predominantly to what it termed the "security factor," and therefore the deposit should be treated like a deposit to secure against property damage or a loan, notwithstanding that the utility can still use the money as it chooses and obtain an economic benefit from that use by achieving a return greater than the prescribed interest rate (Pet. App. 14a).

deposited funds and to derive a substantial economic benefit from that use. In fact, the impact of the particular interest obligation in this case appears to have been relatively insubstantial. Prior to the amendment of the PSCI rules in March 1976, respondent paid only three percent interest on the deposits, and no interest at all if the deposits were held for less than six months. After the amendment of the rules, the interest rate rose to six percent, but respondent was not required to pay any interest at all on deposits unless they were held for twelve months. During the post-March 1976 period covered by the amended PSCI rules, it would appear likely that respondent paid little interest on deposits. Respondent was required to refund the deposit of a customer who timely paid nine consecutive bills or ten out of twelve consecutive bills. Thus, the deposits to which the interest requirement would actually attach would be the relatively small group belonging to customers with erratic patterns of payment—namely, those who were neither consistently timely (which would have entitled them to a refund before twelve months) nor consistently untimely (which would have resulted in their termination as customers and the application of their deposits to their unpaid bills). Thus, it seems clear that, despite the presence of an interest obligation, respondent was required to turn over to its customer only a relatively small portion of the investment profit that it made upon the use of the deposited funds.[12]

The court of appeals' focus on the existence of an interest obligation is theoretically unsound. Interest is a means of adjusting the burdens and benefits of a par-

[12] Moreover, even with respect to the interest that respondent did pay over to its customers, it was entitled to take a deduction for the amount of that payment and to retain the investment return that it earned on that interest while it was in respondent's possession.

ticular financial transaction to account for the time value of money; it is not a benchmark for identifying a nontaxable security deposit. An advance payment, just as much as a security deposit, implicates the time value of money. In the case of an advance payment, that value may more often be reflected by a discount to the customer for advance payment, rather than by a subsequent interest payment to him, but there is no meaningful economic distinction between the two types of adjustments. "[A]ll deferred payment transactions include interest, either explicitly or impliedly," and that principle applies equally to sales on credit and to "advance payment transactions," *i.e.*, transactions in which "the party who gives cash performs first and the party who gives a nonmonetary consideration performs second" (Lokken, *The Time Value of Money Rules*, 42 Tax L. Rev. 1, 11 & n.5 (1986)). See also Halperin, *Interest in Disguise: Taxing the "Time Value of Money"*, 95 Yale L.J. 506, 515-519 (1986). The extent to which the recipient of the benefit of the time value of money in a deferred payment transaction incurs a reciprocal interest obligation is a function of the relative strengths of the parties' bargaining positions (or, as in this case, a requirement of law). The presence or absence of such an obligation, however, provides no basis for distinguishing between an advance payment of income and a nontaxable security deposit.[13]

[13] The irrelevance of an interest obligation to the question presented in this case is further evidenced by the treatment of security deposits in state statutes regulating rental agreements, which vary widely in the extent to which they require landlords to account to tenants for interest earned on security deposits. Florida and New York require deposits to be held in escrow accounts with title to the funds remaining vested in the tenant. See Fla. Stat. Ann. § 83.49 (West 1987); N.Y. Gen. Oblig. Law § 7-103 (McKinney 1989) (landlord may deduct administration fee). Other states specify that interest must be paid on return of the deposit. See, *e.g.*, Md. Real Property Code Ann. § 8-203 (1988) (escrow account and four percent interest owed on return of deposit); Va. Code Ann. § 55-248.11 (1986) (unrestricted use but obligation to pay five percent interest to tenant); Pa. Cons. Stat. § 250.511 (1988) (option of escrow account or bond, but payment of interest required). N.H. Rev. Stat. Ann. § 540A:6 (1988) (escrow account or bond option, five percent interest). Other states require deposits to be placed in a trust account, but do not require the landlord to pay any interest earned to the tenant. See Iowa Code Ann. § 562A.12 (West 1989) (expressly providing that interest is the property of the landlord); Ky. Rev. Stat. § 383.580 (Baldwin Supp. 1988); Me. Rev. Stat. Ann. tit. 710-A, §§ 6033, 6038 (1988). Michigan and Georgia give the landlord the option of holding the funds in an escrow account or of posting a bond and then using the funds for its own purposes with retention by the landlord of the investment return. Mich. Comp. Laws Ann. §§ 554.601 to 554.604 (West 1988); Ga. Code Ann. § 44-7-30 to 44-7-36 (1982). Moreover, the definition of security in these statutes sometimes explicitly covers both deposits to protect against property damage and prepayments of rent. See Cal. Civil Code § 1950.5(b) (West 1988); Mich. Comp. Laws Ann. § 554.601(e) (West 1988); Fla. Stat. Ann. § 83.49 (West 1987); Va. Code Ann. § 55-248.4(*l*) (1986); Md. Real Prop. Code Ann. § 8-203(a) (1988).

Thus, the Eleventh Circuit correctly recognized the immateriality of an interest obligation in the utility deposit context, finding that "interest may reflect compensation for the advance payment of income items as well" as for the use of a security deposit (*City Gas Co.* v. *Commissioner*, 689 F.2d at 948 n.7). That observation accords with the view of other courts that have found interest not to be a significant factor in this context. See *United States* v. *Williams*, 395 F.2d 508, 511 (5th Cir. 1968); *Commissioner* v. *Lyon*, 97 F.2d 70, 74 (9th Cir. 1938).[14] Here, respondent required its customers to make payments in

[14] Indeed, the Tax Court in its original decision in *City Gas Co.* v. *Commissioner*, 74 T.C. 386, 392 n.7 (1980), discounted the significance of an interest obligation as a basis for distinguishing between taxable advance payments and nontaxable security deposits.

advance of their receipt of services. The payment of interest reflects an obligation to compensate those customers for having lost the use of their money. It does not, however, mean that the deposited funds remain the customer's money, and therefore the interest obligation is not inconsistent with taxation of the funds as income to the utility upon receipt.

In sum, the court of appeals erred in attaching overriding significance to the presence or absence of an obligation to pay interest to the customer on payments deposited with the utility. That factor provides no logical or economic basis for distinguishing between an advance payment for services to be provided in the future and a deposit to secure the payment of future bills for such services. Moreover, the presence of an interest obligation is particularly insignificant in this case, where the level of the interest obligation was such that it clearly did not substantially interfere with respondent's control over the deposited funds and its ability to earn a considerable investment return on its use of them. Thus, respondent's payment of interest in this case plainly does not justify the court's departure from the logical import of its recognition that an advance payment and a deposit to secure the payment of future income are essentially the same thing.

D. The Tax Court's "Facts and Circumstances" Test Is Erroneous And Unworkable

The Tax Court did not purport to hold that the tax treatment of utility customer deposits turns exclusively on an interest requirement. Instead, the court stated that whether a utility deposit is to be treated as income upon receipt must depend on an examination of "all of the facts and circumstances surrounding a deposit to evaluate the rights retained by the depositor and the rights acquired by

the holder of the deposit" (Pet. App. 34a). In this context, however, such an approach would not only detract from predictability; it would also lead to unwarranted disparities in tax treatment because the factual differences among various utility deposit programs do not outweigh the common truth that such deposits cannot meaningfully be distinguished from advance payments.

For example, the factors cited by the Tax Court in this case do not support the conclusion that the payments in question should be treated as nontaxable security deposits. The court regarded as "very significant" the fact that the payments were required from only the segment of respondent's customers found not to be creditworthy (Pet. App. 34a). But that fact is equally consistent with viewing the deposits as advance payments. As we have noted (page 18, *supra*), a vendor ordinarily is most interested in obtaining payment in advance from a customer whom the vendor does not trust to pay his bills. The focus on creditworthiness shows only that respondent's concern was with collecting its income; it does not suggest that the deposit should not be regarded as an advance payment of that income taxable upon receipt.

The Tax Court also adverted to the control that the customers could exercise over the ultimate disposition of the deposit—namely, that those customers who established their creditworthiness could choose whether to have the deposit credited against a bill or refunded by cash or check (see Pet. App. 35a). This element of "control" is insignificant. First, as we have noted, there is no meaningful difference between applying the deposit to the customer's account or exchanging a check from the utility in the amount of the deposit with a check from the customer making full payment of the outstanding bill. In any event, even if there were more significance to this choice, it is dif-

ficult to see why the customer's control over the mode of repayment is relevant to the tax question here. Surely, if respondent's practice were invariably to return the deposit by check to a customer who has demonstrated his creditworthiness, it is inconceivable that the absence of the opportunity for the customer to choose to have the deposit applied to his account would justify a difference in tax treatment in the two cases.[15]

Finally, the Tax Court noted that respondent "consistently treated the deposits as belonging to the customers" in its accounting and in describing the payment as a deposit on a receipt provided to the customer (Pet. App. 35a-36a). The court erred in relying on this factor. Clearly, the correct tax treatment must turn on the substance of the payment, not its label. As the Second Circuit stated in considering whether a particular payment was an advance payment of rent or a deposit to secure the performance of lease covenants (*Hirsch Improvement Co.* v. *Commissioner*, 143 F.2d at 915): "It is * * * unimportant how taxpayer regarded or treated it. Its character turns on the terms of the lease itself." Respondent's accounting practices are also of little relevance. It is well established that financial accounting does not necessarily control tax accounting, in part because "financial accounting has as its foundation the principle of conservatism," which skews its techniques toward "understatement * * * of net income" (*Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522, 542 (1976) (internal quotation marks omitted)). See also *Commissioner* v. *Idaho Power Co.*, 418 U.S. 1, 15 (1974); *American Automobile Ass'n* v. *United States*, 367 U.S. at 692-693. Indeed, the question of deferral of income—in particular, the treatment of advance payments—is one area where it is recognized that there is "a large gap between generally accepted principles of financial accounting and the tax rules of accounting" (Stanger, Vander Kam & Polifka, *supra*, 33 Tax Law. at 416).

[15] The Tax Court's reliance on the escheat of unclaimed deposits to the state (see Pet. App. 35a) is similarly misplaced. It is true of every deposit or advance payment that the payment should be returned to the purchaser if the seller fails to provide the agreed-upon services or if the purchaser otherwise has fully paid for the services provided. That possibility of return of the advance payment has never been regarded as a ground for failing to treat the payment as income upon receipt. When the circumstances justifying such returns arise, it is surely of no consequence to the tax treatment of the original payments to the seller whether the money is always paid over to the purchaser or, alternatively, whether, in a small percentage of the cases, the money is paid over to the state.

In sum, the Tax Court's approach is a "non-test." It invites courts to treat essentially identical deposit programs differently, depending upon the significance that each court believes should attach to various diverse factual details—all of which have little bearing on the correct tax treatment of the transaction.[16] The more fundamental

[16] The peculiar results that are likely to arise under this approach are illustrated by *Oak Industries, Inc.* v. *Commissioner*, 52 T.C.M. (CCH) 1556 (1987). In that case, the Tax Court held that a large deposit required by a subscription television company, which could be applied either for the repair of damage to equipment or to cover unpaid fees and charges, was taxable as income upon receipt. In this case, the Tax Court distinguished *Oak Industries* on the ground that the deposits in that case "were credited to final bills for between 61 and 70 percent of all customer terminations" (Pet. App. 36a n.6). In the instant case, between 57.7% and 69% of the amounts deposited were credited to customer bills (*id.* at 25a). The Tax Court also noted two other purported factual distinctions between this case and *Oak Industries*, which have been described as of "questionable significance" (Burke & Friel, *supra*, 12 Rev. Tax'n Individuals at 173 n.67)—that the television company had a well developed delinquent account collection system and that it required all customers to make deposits (Pet. App. 36a n.6).

flaw in the Tax Court's approach is that it directs the courts to make a factbound determination of whether a particular payment is intended as a deposit to secure the payment of future income or as an advance payment of that future income—when there is no practical difference between the two choices. In contrast, the Commissioner and the Eleventh Circuit have correctly determined that a deposit to secure the payment of future income, such as the typical utility customer deposit, must be treated as an advance payment for goods or services to be provided in the future and therefore taxed as income upon receipt.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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RESPONDENT'S

BRIEF

(6)

In the Supreme Court of the United States

October Term, 1968

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

INDIANAPOLIS POWER & LIGHT COMPANY,
Respondent.

On Writ of Certiorari
to the United States Court of Appeals
for the Seventh Circuit

BRIEF FOR THE RESPONDENT

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QUESTION PRESENTED

Whether interest-bearing, refundable security deposits collected by a regulated public utility from a limited class of customers and returned when the customers establish creditworthiness are includible in the utility's income.

RULE 28.1 LISTING

The information required by Rule 28.1 is set forth in the "Rule 28.1 Listing" submitted to the Clerk of the Court with a letter from counsel for respondent dated February 28, 1989. Such information remains accurate as of this date.

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In the Supreme Court of the United States

OCTOBER TERM, 1988

No. 88-1319

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

INDIANAPOLIS POWER & LIGHT COMPANY,
Respondent.

On Writ of Certiorari
to the United States Court of Appeals
for the Seventh Circuit

BRIEF FOR THE RESPONDENT

STATEMENT OF THE CASE

A. Statement of the Facts.

Respondent Indianapolis Power & Light Company ("IPL") is a regulated public utility engaged in generating and selling electricity and steam in Indianapolis, Indiana, and neighboring areas. (Pet. App. 2a and 20a). During the years in issue, IPL collected security deposits from certain of its customers (constituting approximately 5% of its total customer base) who could not meet creditworthiness standards. The receipt issued to such customers stated that the deposits were "to insure

prompt payment of electrical service." (Pet. App. at 2a). Commercial customers often made different arrangements in lieu of cash deposits, including submission of letters of credit or the pledge of assets. (Pet. App. at 20a). When a customer demonstrated creditworthiness, the deposit was refunded. (Pet. App. at 2a). Unclaimed deposits escheated to the state. (Pet. App. at 4a).

Prior to March 10, 1976, the determination of whether a deposit was required was based on a creditworthiness analysis, but no fixed formula was used. (Pet. App. at 2a). As a result of an amended regulation by the Public Service Commission of Indiana, effective March 10, 1976, a fixed formula was prescribed thereafter for residential customers. Deposits could be required of new residential customers who failed the prescribed test and existing residential customers who had a history of late payments. The amended rules also required IPL to increase the rate of interest payable on deposits held for more than twelve months from 3% to 6%. (Pet. App. at 3a).

Prior to March 10, 1976, a customer could obtain a refund of the deposit by requesting such a refund and demonstrating his or her creditworthiness. (Pet. App. at 2a). Such a refund was usually made in cash or by check but could be credited to the customer's bill if the customer requested. (Pet. App. at 22a). The manner in which such refund was made was determined by the customer. (Pet. App. at 3a).

After March 10, 1976, a residential customer's deposit was refunded if the customer paid his or her bill on a timely basis for nine consecutive months or for ten out of twelve months (as long as the two delinquent months were not consecutive). Alternatively, the customer could obtain a refund by satisfying the prescribed creditworthiness test. These refunds were made

in cash or by check unless the customer requested an offset against the bill. Upon termination of service, the deposit was generally offset against the customer's final electric bill unless the customer requested otherwise. (Pet. App. at 3a). During the years in issue, 31% to 42% of the refunds were returned in the form of cash or checks. (Pet. App. at 25a).

IPL did not segregate the customer deposits from its other assets. (Pet. App. at 3a). IPL was required by the rules of service of the Public Service Commission of Indiana to treat unrefunded deposits as liabilities and not as income for regulatory accounting purposes. (Pet. App. at 4a, n. 3). Such treatment was in accord with generally accepted accounting principles and clearly reflected income for financial accounting purposes. (Pet. App. at 24a).

IPL consistently applied this same accounting approach for both financial accounting and tax purposes for at least fifty years. (Stip. Facts ¶ 20; and Tr. 11). Petitioner Commissioner of Internal Revenue (the "Commissioner") first questioned this treatment in connection with IPL's 1975 taxable year, taking the position that such deposits were in reality advance payments and should be included in IPL's income for that year. (Pet. App. at 1a).

B. Decisions Below.

In a unanimous opinion reviewed by the full court, the Tax Court rejected the Commissioner's challenge to IPL's treatment and found that the refundable deposits collected by IPL from its noncreditworthy customers were not includible in its income. (Pet. App. at 19a-39a). In reaching this decision, the Tax Court's inquiry was directed at evaluating all the facts and circumstances to determine "the rights retained by the depositor

and the rights acquired by the holder of the deposit." (Pet. App. at 34a). In evaluating those rights, the Tax Court found it significant that (a) the deposits were not intended as advance payments; (b) the depositor -- the customer -- had the right to control the ultimate disposition of the deposit and IPL's rights in the disposition of the deposit were minimal; and (c) IPL treated the deposits as belonging to the customer and paid interest on the deposit. (Pet. App. at 34a-36a).

On appeal, the Court of Appeals for the Seventh Circuit affirmed the Tax Court's decision, holding that the deposits served as security and not as prepayments. (Pet. App. at 17a). The Seventh Circuit rejected the *per se* rule proposed by the Commissioner which would treat any deposit that primarily secured the payment of future bills for utility services as a taxable advance payment and any deposit that primarily secured property rights as nontaxable. Rather, after observing that when interest is paid on the deposit, the "return factor" from holding the deposit is minimized and the principal benefit of either type of deposit is the "security factor," the Court of Appeals adopted the "facts and circumstances" test utilized by the Tax Court and concluded that the deposits did not constitute income on receipt.

SUMMARY OF THE ARGUMENT

The Tax Court and Court of Appeals held that the refundable security deposits received by IPL were not advance payments of income and therefore were not properly includible in its gross income. This holding was fully supported by prior decisions of this Court construing the meaning of "gross income" under the Internal Revenue Code. Those cases hold that income arises only when a taxpayer experiences some accession to wealth. Amounts are not included in income if they are obtained subject to a consensual recognition of an obligation to repay.

Under these principles, customer deposits collected by IPL were not income because they were received subject to an acknowledged obligation to repay the deposits upon conditions solely within the control of the customers. To obtain a refund, the customers were required to do merely what they had a duty under the law to do -- pay their bills in a timely fashion for a given period of time. Thus, the deposits were simply held as a stand-by security device until the customer demonstrated creditworthiness or, if he did not, unless and until he defaulted. IPL was essentially in the same position as the holder of loan receipts, bank deposits, or property damage deposits. Prior to a customer default, the accession to wealth required for taxation had not occurred.

Furthermore, the deposit was not received in exchange for the promise to provide future goods or services, a basic element of a taxable advance payment. The receipt of a customer's deposit did not obligate IPL to provide utility services to the customer and did not obligate the customer to receive utility services. The deposit was normally not even a condition for obtaining or continuing service.

IPL also paid interest on the deposits at rates set by the Public Service Commission of Indiana. This indicates that the Public Service Commission intended that IPL act like a custodian of the deposit, similar to a bank holding interest-bearing bank deposits. It also confirms that the primary benefit of the deposit to IPL was its function as a security device and not the earning of a return on the deposited sum.

As the Seventh Circuit and the Tax Court held, these various facts pertaining to the deposits have to be evaluated to determine the respective rights of IPL and the customers in the deposits. Only by such an analysis can it be determined whether the customer has relinquished and IPL has acquired sufficient rights in the deposits to warrant taxing IPL on these sums. The Commissioner's proposed test -- that deposits primarily securing the future payment of utility bills should always be taxed while deposits securing property rights, such as damage deposits, should be nontaxable -- should be rejected for several reasons.

First, cases analyzing the tax treatment of lease deposits have not distinguished between bona fide security deposits and advance rental payments on the basis of the type of lease covenants secured by the deposit.

Second, the economic effect of a deposit of the type received by IPL is not equivalent to the receipt of an advance payment. In IPL's case, the deposit was not earmarked for payment of a particular bill for goods or services. IPL had an unequivocal duty to refund the deposit under conditions within the customer's control, and the customer determined whether the deposit refund was in cash or by an offset on a utility bill.

Third, contrary to the Commissioner's position, there is no material distinction between a deposit which secures payment of a future utility bill and one that secures some tangible property interest. In both cases, the deposit is refundable unless the conduct being secured against occurs. The deposit holder in each case has the same offsetting refund obligation that precludes any increase in his net worth. Finally, the utility security deposit secures an asset -- an account receivable -- just as a typical property damage deposit secures a tangible asset. For an accrual basis taxpayer such as IPL, income is generated as services are delivered and completely without regard to whether the utility bills are even collected. Upon a customer default, deposits are applied to reduce collection costs and to minimize bad debt expenses. The deposits are never converted into income.

Fourth, because income is recognized as utility services are delivered, the result of including the deposit in income at the time of collection would be to double count the income for the applicable time period.

Fifth, the principal case relied on by the Commissioner, *City Gas of Florida v. Commissioner*, 689 F.2d 943 (11th Cir. 1982), *rev'g and remanding*, 74 T.C. 386 (1980), is distinguishable on its facts in several material respects. In that case, deposits were collected from all new customers and were generally held until termination of service and applied against final utility bills with no possibility of a refund except for the unapplied amount. The utility did not make pre-termination refunds under any conditions.

The Commissioner criticizes the application of the "facts and circumstances" analysis in resolving the taxability of utility deposits. However, the Commissioner's proposed *per se* test

based on the nature of the covenants secured by the deposit conflicts with both legal precedent and the economic substance underlying utility deposits. It also erroneously excludes from the inquiry those facts that are most indicative of the holder's rights in the deposits and thus are the most crucial to resolving whether the payments represent the accession to wealth upon which taxability is predicated.

Indeed, in analogous situations where a determination must be made whether, from the payor's standpoint, an amount constitutes a deductible advance payment or a nondeductible deposit, the Commissioner advocates basically this same facts and circumstances test, presumably because it works to his advantage in such cases. Consistency, economic reality, and prior precedent require that a similar facts and circumstances test be applied in all cases. When that is done, it is clear that the customer deposits here should be classified as true deposits and not as prepayments for services.

ARGUMENT

I. The Lower Courts' Analysis and not the Commissioner's Is Consistent with Precedent and Accepted Principles for Determining Gross Income.

A. Under Controlling Decisions of This Court, Cash Receipts Are Not Includible in Income If Offset by a Corresponding Repayment Obligation.

The Commissioner seeks to treat the refundable security deposits received by IPL as advance payments of income. However, the prior decisions of this Court fully support the Tax Court's and Court of Appeals' conclusion that the deposits were not includible in gross income.

This Court has considered the proper scope of the term "gross income" on numerous prior occasions. The early decisions fashioned a definition of income along the lines stated in *Eisner v. Macomber*, 252 U.S. 189, 207 (1920): income is "the gain derived from capital, from labor, or from both combined." Later cases, such as *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931), broadened the definition somewhat. *Kirby Lumber* held that a corporation's repurchase of its own bonds at less than their face value resulted in the realization of income in an amount equal to the difference between the repurchase price and the face value because of the enrichment resulting from the corporation's being relieved of its obligation to retire the bonds at face at maturity. The corporation was described as having realized "an accession to income." *Id.* at 3.

In more recent cases, the early formulations of what constituted income received further elaboration. Thus, in *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955), the question was

whether the punitive portion of a treble damage award should escape tax as a mere "windfall." In what has now come to be generally accepted as the definitive articulation of the scope of the term "gross income" as used in the Internal Revenue Code, this Court held that the damage award was fully taxable:

> Here we have instances of *undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion.*

Id. at 431 (emphasis added).

The *Glenshaw Glass* definition of what constitutes income was restated and amplified in *James v. United States*, 366 U.S. 213 (1967), to take into account the fact that the funds there in question had been obtained through embezzlement:

> *When a taxpayer acquires earnings, lawfully or unlawfully, without the consensual recognition, express or implied, of an obligation to repay and without restriction as to their disposition, 'he has received income which he is required to return*, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.'. . . *This standard* brings wrongful appropriations within the broad sweep of 'gross income'; it *excludes loans.*

366 U.S. at 219 (emphasis added) (citations omitted).[1]

[1] *See also Commissioner v. Tufts*, 461 U.S. 300 (1983):

> When a taxpayer receives a loan, he incurs an obligation to repay that loan at some future date. Because of this obligation, the loan proceeds do not qualify as income to the taxpayer. When he fulfills the obligation, the repayment of the loan likewise has no effect on his tax liability.

Id. at 307.

Under the *James* rule, therefore, even if the taxpayer has unfettered control over the funds in question, if there also exists a consensual recognition of an obligation to repay the funds, there cannot be the requisite "accession to wealth" that is the *sine qua non* of taxability.

Consistent with these principles, this Court has approved the current taxation of amounts received as advance payments in exchange for goods or services to be provided in the future. These payments differ markedly from loans and other receipts that produce no increase in a taxpayer's net worth. *See Schlude v. Commissioner*, 372 U.S. 128 (1963); *American Automobile Association v. United States*, 367 U.S. 687 (1961); and *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180 (1957). In those cases, the taxpayers had used the accrual method of accounting, under which income is recognized as it is earned by the performance of services or the provision of goods promised by the taxpayer. The Commissioner required the taxpayer to include the customer advance payments in gross income upon receipt instead of in the year to which they were allocated under the taxpayers' accrual method. The Court concluded that, under the facts of those cases, the Commissioner was allowed to exercise his discretion under § 446 of the Internal Revenue Code (26 U.S.C.) to apply an accounting method that he believed more clearly reflected income.

This trilogy of accounting method cases involved taxpayers who had received payments in exchange for the express promise to provide specific services in subsequent periods. The payments were tied directly to those services and were not refundable. There was no question in any case that the taxpayers' performance of those services would generate income. The

only issue was one of timing of the recognition of what was admittedly income.

In summary, the difference between advance payments and nontaxable cash receipts such as loans is as follows. Advance payments are cash sums received by a taxpayer who, in exchange, promises to provide goods or services. Absent a breach of contract, the taxpayer has no obligation to return the cash. His duty is simply to perform the services or provide the goods promised under the agreement. By contrast, although loans also involve the receipt of cash, the taxpayer promises in return to repay that cash, normally along with interest to compensate the lender for the use of the money. If the taxpayer performs his contractual obligation, he will return the borrowed funds plus interest. The obligation to repay the funds is a liability which offsets the cash assets received. The borrower thus experiences no increase in his net worth, *i.e.* no "accession to wealth," an indispensable prerequisite to taxation. *James v. United States*, *supra*; *Indianapolis Power & Light Company v. Commissioner*, Pet. App. 7a.

Under these general principles, advance payments are equally distinguishable from receipts which are similar to loans, *e.g.* bank deposits,[2] deposits in the nature of cash bonds,[3] performance bonds,[4] and security deposits.[5] While a security

[2]Rev. Rul. 71-189, 1971-1 C.B. 32 (inactive bank deposits are not includible in income until the bank takes affirmative action to assert dominion over such accounts); *Fidelity-Philadelphia Trust Co. v. Commissioner*, 23 T.C. 527 (1954) (same).

[3]*See, e.g., United States v. Consolidated Edison*, 366 U.S. 380 (1960); *Rosenman v. United States*, 323 U.S. 658 (1944).

[4]*See, e.g., Fiore v. Commissioner*, 39 T.C.M. (CCH) 64, 76.

[5]*See, e.g., Mantell v. Commissioner*, 17 T.C. 1143 (1952).

deposit may not be repaid in all instances (as where the payor fails to perform as required), the recipient holds the funds under an obligation to repay them at some future point in time unless default occurs. As stated in the context of a lease deposit, "[i]n this situation the acknowledged liability of the lessor to account for the deposited sum on the lessee's performance of the lease covenants prevents the sum from being taxable in the year of receipt." *J. & E. Enterprises, Inc. v. Commissioner*, 26 T.C.M. (CCH) 944, 946 (1967). As with a loan, there is no accession to wealth justifying taxation because of the deposit recipient's obligation to refund and the payor's unilateral ability to cause that obligation to remain in place.[6]

The Court of Appeals found these principles controlling in evaluating the tax treatment of a deposit, which it found to be "analogous to the typical cash loan." (Pet. App. 7a).

[6]The Commissioner's suggestion that the "claim of right" doctrine (Pet. Br. 13 n.5) supports its position in the instant case is totally unfounded. In *North American Oil Consolidated v. Burnet*, 286 U.S. 417 (1932), where the claim of right doctrine originated, the sole question at issue was *when* (*i.e.*, in which year) royalties which indisputably constituted income items should be taxed. In sharp contrast, the issue presented in the instant case is *whether* the deposits should be taxed at all. In *James*, *supra*, the government itself admitted that the claim of right doctrine is properly invoked solely "to determine *when*, not *whether*, receipts constituted income." 366 U.S. at 216 n.7 (emphasis in original). Moreover, the refundable customer security deposits here involved were not collected under a "claim of right" because respondent was required to, and did in fact, treat the deposits as liabilities, not income, while held.

B. The Tax Court and Court of Appeals Correctly Held That IPL's Rights in the Deposits Were Too Minimal To Justify Taxation.

1. The Lower Courts' Decisions Were Fully Supported by the Facts.

In its decision below, the Tax Court adhered to the traditional approach of "examin[ing] all of the facts and circumstances surrounding a deposit to evaluate the rights retained by the depositor and the rights acquired by the holder of the deposit." (Pet. App. 34a). Under this approach, an amount is considered an advance payment when the "taxpayer has virtually unrestricted control over the amount deposited and does not pay interest on such amount." *Id.*

The following facts supported the Tax Court's conclusion that the "deposits were not advance payments of income but were temporarily held by [IPL] to secure payment of the bills . . ." (Pet. App. 36a):

1. The deposits were intended as a security device because they were collected from only noncreditworthy customers, about 5% of the customer base.

2. The customer controlled the disposition of the deposit because he could secure a refund by demonstrating creditworthiness.

3. IPL had minimal rights in the deposit because it had to account to the customer for the deposit until such time as the customer defaulted.

4. Unclaimed deposits escheated to the state.

5. IPL consistently treated the deposit as belonging to the customer.

6. IPL paid interest on the deposit.

7. Under state utility regulations and generally accepted accounting principles, IPL was required to record the deposits as liabilities to customers.

(Pet. App. 34a-36a).

In affirming the Tax Court, the Seventh Circuit stated:

> The difficulty in these type of cases arises because the deposit to secure an income payment is given in conjunction with a contractual arrangement that also generates an income stream to the deposit recipient. The temptation, as the IRS's position demonstrates, is to always collapse the two. We hold only that this result is not automatically required. We therefore retain the traditional approach of analyzing the facts and circumstances to determine whether the principal purpose of a 'deposit' is to secure future performance or to serve as an advance payment of income.

(Pet. App. 16a-17a).

In applying this approach, the Seventh Circuit upheld the Tax Court's factual determination that the customer deposits were not prepayments of income. Three facts in particular were persuasive to the Court of Appeals: The customers received interest on the deposits, the customers controlled the refund of the deposits, and IPL never intended that the deposits would serve as prepayments. These facts, as well as the others relied on by the Tax Court, establish that the deposits were held subject to a repayment obligation that brought them within the *James* rule. They were analogous to interest-bearing loans and were not received as consideration for the delivery of utility services by IPL.

The Court of Appeals rejected the argument which the Commissioner presents to this Court, i.e. deposits primarily securing the future payment of utility bills should always be taxed while deposits securing property rights, such as a damage deposit, should be nontaxable. Although the case involved different facts, the Commissioner relied primarily on *City Gas of Florida v. Commissioner*, 689 F.2d 943 (11th Cir. 1982), *rev'g and remanding*, 74 T.C. 386 (1980). In *City Gas*, deposits were collected from all new customers and were generally held until termination of service and applied against final utility bills with no possibility of a refund except for the unapplied amount. The utility did not make pre-termination refunds under any circumstances. In ruling that the deposits in *City Gas* were taxable, the Eleventh Circuit established the following dichotomy:

> [T]he test to be applied in this case is whether, under all the circumstances, the primary purpose of the payments at issue was a prepayment of income items, or whether the primary purpose was to secure the performance of nonincome-producing covenants.

689 F.2d at 948. In the decision below, the Seventh Circuit observed that the Eleventh Circuit's phrasing of the test in *City Gas* could imply that a deposit securing the future payment of bills is always taxable as a prepayment. (Pet. App. 9a). It rejected that position because neither prior case law nor the underlying substance of IPL's deposits supports such a proposition.

2. Bona Fide Security Deposits Are Nontaxable Regardless of the Nature of the Covenants Which They Secure.

The Commissioner has relied on a line of cases analyzing the tax treatment of lease deposits in formulating the position that deposits primarily securing the future payment of utility bills are taxable while deposits primarily securing property interests are not. Rev. Rul. 72-519, 1972-2 C.B. 32. (Pet. Br. 14). Those cases do not support the Commissioner's position.

In cases involving real estate lessors, the courts have found it necessary to distinguish between the taxable receipt of an advance payment of rent and a nontaxable receipt of a tenant's security deposit. The payment of a sum earmarked for application to a fixed month's rental bill is consistently held to constitute an advance payment of rent. *See, e.g., Astor Holding Co. v. Commissioner*, 135 F.2d 47 (5th Cir. 1943), where the amount was agreed to be "part payment of the tenth year's rent." In such a case, the payment is received in exchange for the landlord's promise to provide the leasehold premises through the end of the lease term. The tenant is bound to pay the rent for the entire lease term. The payment in issue is earmarked as applicable to a particular period's rent and is not refundable. Under these circumstances, the earmarked sum is obviously an advance payment of the later period's rent. However, a security deposit is something quite different, as the court recognized in *Astor*:

> If an amount is deposited with a lessor merely as security for the performance of covenants, with no present right or claim of full ownership in the lessor, it is not treated as taxable income unless and until something happens to make the deposit, or a portion of it, the property of the lessor. Whether a payment falls into one category or the other depends upon the facts of the particular case.

135 F.2d at 48 (citation omitted).

In certain of the cases, the lease provided that an amount earmarked for application as rent in a future period may also be applied for some other purpose (such as toward the exercise of a purchase option), *Gilken Corp. v. Commissioner*, 10 T.C. 445, 454 (1948), *aff'd*, 176 F.2d 141 (6th Cir. 1949), or might have to be refunded upon certain contingencies, *Hirsch Improvement Co. v. Commissioner*, 143 F.2d 912, 915 (2d Cir. 1944), *aff'g*, B.T.A. Memo (P-H) ¶ 42,559 (1942). In these dual-purpose situations (where one purpose is clearly the advance payment of rent), the primary purpose of the payment has to be determined. If the primary purpose is something other than the advance payment of rent -- such as securing the tenant's performance of the lease obligations -- the deposit is not taxable.[7] Contrary to the Commissioner's position in Rev. Rul. 72-519, 1972-2 C.B. 32, therefore, the lease deposit cases hold that a payment that primarily secures the performance of lease

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[7] *Cf. Mantell v. Commissioner*, 17 T.C. 1143 (1952), where the amount was primarily intended to secure various covenants -- both income- and nonincome-producing -- and was not to be applied as rent. 17 T.C. at 1148.

[8] *Mantell v. Commissioner*, 17 T.C. 1143, 1148 (1952) ("[i]n some instances the deposit serves as *security for the lessee's performance* . . . .") (emphasis added); *Hirsch Improvement Co. v. Commissioner*, B.T.A. Memo (P-H) ¶ 42,559, at p. 42,998.446 (1942), *aff'd*, 194 F.2d 912 (2d Cir. 1944) ("[i]f, on the other hand, the payment is a deposit to *secure the lessee's performance under the lease* . . . .") (emphasis added); *Gilken Corp. v. Commissioner*, 10 T.C. 445, 451 (1948), *aff'd*, 176 F.2d 141 (6th Cir. 1949) ("if money is merely deposited by the lessee with the lessor as *security for the performance by the lessee of the covenants and provisions of the lease* . . . .") (emphasis added).

covenants, without distinction as to whether these are income or nonincome-producing obligations,[8] is not taxable.

The Seventh Circuit agreed that the test for determining the appropriate tax treatment of deposits requires an evaluation of the primary purpose of the deposit based on all the facts and circumstances but necessarily rejected the conclusion that this test requires that a deposit securing the future payment of bills must always be taxable as an advance payment. (Pet. App. 11a). The Tax Court also refused to accept any such interpretation of the lease deposit cases. (Pet. App. 33a).

Thus, where a security deposit is intended to secure future performance, is acknowledged to be a liability, is treated that way in practice, and is unconditionally subject to refund to the depositor with interest, it is not an advance payment regardless of the character of the covenants it secures.

3. The Court of Appeals Was Correct in Emphasizing IPL's Obligation To Pay Interest on the Deposits and To Refund Them upon Conditions within the Customers' Control.

In analyzing the differences between advance payments and security deposits, the Seventh Circuit posited two extreme hypotheticals.

The first explored the substance of a payment over which the deposit holder had virtually unrestricted control. In this example, a so-called "deposit" was held by a landlord until the final month's rent payment was made. The Court of Appeals noted that the Commissioner saw a functional similarity in this situation between the "deposit" and an advance payment of rent. (Pet. App. 10a). This, of course, is a much different set of facts from IPL's situation because it involves sums which are matched to and essentially earmarked for the final month's rent

and are not refundable before then. Customer deposits received by IPL were refundable as soon as a customer attained credit-worthiness and were not earmarked for payment of a given bill for services.

The Court of Appeals outlined the second extreme case to demonstrate that, when the interest payable on a deposit equals the deposit holder's investment return on the deposited sum, the only benefit he receives from the use of the deposit is security against the collection costs and other losses arising in case of customer default. In this situation, the benefits of the security factor are essentially the same for deposits securing against property damage defaults and for deposits securing against defaults on bills for goods or services.[9] (Pet. App. 14a-16a).

Although the Seventh Circuit considered the payment of interest a very important factor (Pet. App. 17a), it was only one of the facts supporting its affirmance of the Tax Court's decision. Contrary to the Commissioner's suggestion, the

[9]As an accrual basis taxpayer, IPL recognizes income as it provides utility services and bills customers. *See*, *infra*, pages 31-32. If a deposit is applied to a bill on which a customer has defaulted, the income for the utility services involved will already have been recognized as a result of the prior billing to the customer. Application of the deposit in such a situation would simply offset (to some extent) bad debt expenses and costs of collection efforts against the customer. Similarly, damage deposits applied by a landlord, for example, would be used to offset repair expenses or the costs of replacement property, as well as the costs of collection efforts. The Commissioner agrees that such deposits are not taxable. (Pet. Br. 22-23).

Thus, the utility deposit secures a property right -- an account receivable -- just as much as a property damage deposit. *See* pages 31-32, *infra*. (A more extensive discussion of this point is found at Section A of the Brief Amicus Curiae filed on behalf of American Information Technologies Corporation *et al.* (the "Telephone Companies Amicus Brief").)

Court of Appeals did not hold that the payment of nominal interest would automatically avoid advance payment treatment. (Pet. Br. 26). Instead, it specifically stated that other factors would have to be considered when, as will be usual, it cannot be determined that the interest paid on the deposits matches the holder's investment return. (Pet. App. 17a, n.12).

Especially in the context of regulated public utilities, the payment of interest is a significant factor undermining any policy reason for taxing customer deposits as advance payments of income. The public utility commissions setting the applicable interest rate on deposits can be expected to provide an oversight function in protecting customers and ensuring a rate of interest that is reasonable under the circumstances. The regulatory oversight virtually eliminates the possibility that the deposits' terms will be manipulated to achieve tax avoidance results. *Cf. United States v. Williams*, 395 F.2d 508 (5th Cir. 1968).[10]

Furthermore, the fact that a public utility commission orders the payment of interest on sums collected from customers which are temporarily held prior to refund is a clear indication that the commission intends that the utility is to act like a custodian of

[10]The Commissioner suggests that IPL likely paid little interest on the deposits based on the assumption that deposits were typically refunded within a twelve-month period. (Pet. Br. 27). That suggestion is mere speculation on the Commissioner's part and lacks any support in the record. However, even if such an assumption were correct, the short duration of the deposit holding period would only underscore the customer's unilateral control over the deposit and IPL's limited rights therein. Similarly, the Commissioner's assertion that IPL profited by re-investing the deposits is also speculative. (Pet. Br. 27 and 30). In any event a person who re-invests funds borrowed at a fixed rate of interest can lose, as well as profit, depending on the success of the investment selected.

the deposit, similar to a bank holding interest-bearing bank deposits. *See Illinois Power Co. v. Commissioner*, 792 F.2d 683, 689 (7th Cir. 1986):

> The underlying principle is that the taxpayer is allowed to exclude from his income money received under an unequivocal contractual, statutory, or regulatory duty to repay it, so that he really is just the custodian of the money.

In addition to the payment of interest, the Seventh Circuit and the Tax Court emphasized that the deposits collected by IPL were unconditionally refundable as soon as the customer satisfied his payment obligations for the prescribed period, or upon termination of service if that occurred earlier. The customer controlled both the timing and the occurrence of either event, the first by complying with his agreement to pay for services rendered and the second simply by requesting that electrical services be discontinued. IPL had temporary use of the funds in the interim but had an unequivocal duty to repay them. In this respect, it was no different than the holder of loan receipts, bank deposits, or property damage deposits. Even the deposits of customers who could not be located did not accrue to the benefit of IPL because unclaimed deposits escheated to the state, a fact which further emphasizes that the deposits never became IPL's property except upon a customer default. This fixed obligation to repay, which precluded any increase in IPL's net wealth, brings the deposits within the rule of *James v. United States, supra. See also Illinois Power Co. v. Commissioner*, 792 F.2d 683 (7th Cir. 1986); *Consolidated Hammer Dry Plate & Film Co. v. Commissioner*, 317 F.2d 829 (7th Cir. 1963); *Mutual Telephone Co. v. United States*, 204 F.2d 160 (9th Cir. 1953); *Bates Motor Transport Lines, Inc. v. Commissioner*, 200

F.2d 20 (7th Cir. 1952); *Boston Consolidated Gas Co. v. Commissioner*, 128 F.2d 473 (1st Cir. 1942).

II. A Refundable Security Deposit Is Different from an Advance Payment in Both Purpose and Economic Effect.

The Commissioner advocates a *per se* rule that declares all utility customer deposits securing future utility bills to be the equivalent of the advance payment of income. However, the Commissioner's attempt to ground this test in the "purpose and economic effect" of the deposits ultimately fails. In general, the models on which the Commissioner attempts to rely to justify his economic analysis are simply not the facts of this case and thus provide little guidance in resolving it.

A. The Purpose of the Deposit Is Security, Not the Prepayment of Bills.

The Tax Court found as a matter of fact that IPL never intended that the customer deposits serve as advance payments for utility services. (Pet. App. 24a). The purpose of the deposits was to serve as a standby security device to protect IPL against defaults by a small class of customers with questionable credit status, and the deposit was refundable when that purpose was satisfied by the customer attaining creditworthiness. (Pet. App. 34a). Thus, for at least fifty years[11], IPL reported the deposits as current liabilities to customers, a treatment fully in accord with regulatory requirements and generally accepted accounting principles. *Cf. Boston Consolidated Gas Co. v. Commissioner*, 128 F.2d 473 (1st Cir. 1942). That the deposit was not designed to serve as an advance payment is further demonstrated by the fact that IPL often made alternative arrangements with commercial customers allowing them to satisfy

[11]Stip. of Facts Para. 20; R. 7; and R. 11.

the deposit requirement by submitting letters of credit or pledging noncash assets. (Pet. App. 20a).

The Commissioner's position is, in effect, that where the actual purpose of a refundable deposit is to secure the payment of bills, that purpose should be disregarded and a different characterization applied on the theory that the economic substance of the deposits is identical to advance payments of income. (Pet. Br. 19). However, as the Tax Court and the Court of Appeals correctly found, the economic substance of the deposits here involved is, in fact, consistent with their declared purpose.

B. The Economic Effect of the Deposit Is Essentially Equivalent to a Loan.

1. A Deposit Is Not Received in Exchange for a Promise To Deliver Goods and Services.

The Commissioner's economic analysis begins with a basic exchange model in which buyers make cash payments and sellers supply goods and services in return. The sequence of performance varies from situation to situation. The seller may perform first and later bill the buyer for the goods and services delivered; the exchange of consideration may be simultaneous; or the cash payment may be made in exchange for the seller's promise to deliver goods or services at some future time.

Under the advance payment model, as long as the seller performs as promised, he never has to divest himself of the payment. Although the payment of the cash consideration precedes the performance of the economic activities to be delivered in exchange, the two are nevertheless tied together by the reciprocal promise, thereby affording a basis to tax the cash upon receipt.

The customer utility deposits in the present case do not fit within this exchange model. First, the receipt of a customer's deposit did not obligate IPL to provide some given amount of utility services to the customer, or to provide any utility services at all. (Pet. App. 21a). Likewise, the customer was under no contractual obligation to receive utility services and could secure a refund of the deposit simply by requesting termination of service. The deposit was normally not even a condition for obtaining or continuing service. (Pet. App. 20a). Thus, the deposit was not received in exchange for the promise to provide future goods or services, a basic element of the advance rent and other advance payment cases.[12] The deposit was simply

[12] It is well established that in the application of the Federal tax laws, state law controls in determining the nature of the legal interest which the taxpayer had in the property or income sought to be taxed. *Morgan v. Commissioner*, 309 U.S. 78, 82 (1940); *Aquilino v. United States* 363 U.S. 509 (1960). In this connection, state law also recognizes the difference between an advance payment and a deposit in the case of landlords and tenants. A landlord holding a deposit does not have the same legal rights or economic position as one who receives an advance payment earmarked as rent. In the case of an advance rental payment, the amount paid becomes the lessor's, and he is normally entitled to retain it in its entirety upon the tenant's default, even if default occurs prior to the end of the lease term. *Hargrove v. Marks*, 103 Ind. App. 321, 7 N.E.2d 640, 643 (1937). *Cf. Casino Amusement Co. v. Ocean Beach Amusement Co.*, 101 Fla. 59, 133 So. 559, 561 (1931). But in the case of a security deposit, the amount paid continues to be the tenant's, out of which the lessor can compensate himself for damages upon the tenant's default but must still return the balance. *Edward Rose of Indiana v. Fountain*, 431 N.E.2d 543, 546 (Ind. App. 1982); and *Hargrove v. Marks, supra*. These substantive differences should be disregarded only in cases where the parties attempt to disguise the true nature of the payments to achieve tax avoidance results, an unlikely occurrence in case of deposits required by governmental regulatory authorities. *Cf. August v. Commissioner*, 17 T.C. 1165 (1952); Pet. App. 31a.

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held as a stand-by security device until the customer demonstrated creditworthiness or, if he did not, unless and until he defaulted. Prior to such a default, the deposit lacked any direct nexus with the provision of utility services and could not be used to pay for those services. The mere fact that IPL became entitled to apply the deposit to unpaid bills upon the customer's default is no reason to tax the deposit prior to that time. Until then, the accession to wealth required for taxation has not occurred.

2. A Security Deposit Is Refundable If Both Parties Perform as Agreed.

The other critical feature distinguishing a customer deposit from a prepayment of income is the refundability of the deposit. The Commissioner refers to this as a superficial difference (Pet. Br. 19), but in reality it goes to the heart of the matter.

First, the possibility of a refund of an advance payment for promised goods or services is inapposite. *Cf.* Pet. Br. 19. In the advance payment context, if each party performs as promised, the payment is never returned. Only in the case of a breach of the seller's obligation can the advance payment be recovered. In the utility deposit situation, if each party performs as agreed, the deposit is refunded. And unless the customer voluntarily terminates service, the provision of utility services continues even after the deposit has been returned.

Next, the Commissioner focuses on the "check exchange" analogy in an attempt to equate deposits with prepayments of income. (See Pet. Br. at 17). However, his examples are based on the situation where the deposit is taken as security for the

Similarly, it is clear under state law that in the utility context, advance payments become the property of the utility but security deposits remain the property of the customer.

final lease period's rental obligation. There, the landlord's duty to refund does not arise until he has received payment of the agreed month's rent, *i.e.* he does not divest himself of the cash until he receives an identical amount of cash. Even if the economic equivalency argument could be accepted in the context of deposits to secure a fixed amount of rent for a given month, the analogy breaks down totally when utility customer deposits are considered. Unlike a tenant leasing property, the utility customer does not contract for a given amount of utility service for any stated period. Unlike a landlord, the utility has no present fixed right to a fixed future payment. *Cf. City Gas of Florida v. Commissioner*, 74 T.C. 386, 394-5 (1980), *rev'd*, 689 F.2d 943 (11th Cir. 1982). Only by sheer coincidence would a particular customer deposit match the charge for utility services on the customer's final bill. The Commissioner acknowledges that the check exchange analogy is "not as tidy" in the utility deposit context. (Pet. Br. 20, n.9). That is a great understatement. The check exchange model has no application at all in the utility deposit context.

In *City Gas*, the Commissioner could at least contend that the discrepancy between the deposit refund amounts and the customer charges for gas should be disregarded because the deposit was generally applied against the customer's final bill and was not refundable prior to that time. 689 F.2d at 945, 950. By contrast, in IPL's case customers could obtain a refund of the deposits prior to termination of service through actions inherently within their own control.[13] By merely doing what

[13] In this respect, as well as others, *City Gas* is distinguishable on the facts from the present case. Because deposits were generally held until termination of service and applied against final utility bills with no possibility of a refund except for the unapplied amount, the Eleventh Circuit in *City Gas*, seemingly concluded that one of the

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they had a duty under the law to do -- paying their bills in a timely fashion for a minimum period -- the customers established their creditworthiness and their deposits were refunded.[14]

Moreover, the pre-termination deposit refund was made in cash or by check unless the customer asked that it be credited to his bill. Thus, as the Tax Court found, the customers controlled the manner in which the deposits were refunded. (Pet. App. 22a and 23a). Consequently, IPL was required to stand ready to make refunds in cash, and it often was required to do exactly that. In fact, 31% to 42% of the total deposit refunds were in cash. (Pet. App. 25a).[15] In any event, the manner of refund should not be critical under a system where interest is paid on the deposit, the refund obligation is within the customer's unilateral control, and the customer himself determines whether the refund is in cash or by an offset.

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purposes of the deposits was the prepayment of those bills. Consequently, it apparently believed that a "primary purpose" analysis was necessary under that reasoning (as is evidenced by the Eleventh Circuit's remand of the case to the Tax Court for purposes of determining the primary purpose of the payments). No such primary purpose analysis is needed in the present case because the deposit's only purpose was to be a security device. When no longer needed for that purpose, the deposit was refunded. If *City Gas* is not construed in this manner, it should be rejected as inconsistent with this Court's decisions and the relevant law and cases discussed above.

[14]Under the amended rules of service, IPL refunded a customer's deposit if the customer paid his or her electric bill on a timely basis for nine straight months or for ten out of twelve months (as long as the two delinquent months were not consecutive). (Pet. App. 3a).

[15]Refunds prior to termination were usually made in cash or by check. (Pet. App. 229).

Notably, there is no basis in generally recognized tax law to require the extinguishment of mutual debts prior to the parties' agreement to offset them. *Estate of Lipman v. United States*, 376 F.2d 455 (6th Cir. 1967); *Bailey v. Commissioner*, 103 F.2d 448 (5th Cir. 1939); *Carroll v. Commissioner*, 30 T.C.M. (CCH) 249, 255 (1971). Thus, the possibility of a future offset cannot be used to treat the deposit holder as the owner of the deposit prior to the actual offset. Ultimate disposition of the deposit remains subject to the customer's control until such time as it is either applied in satisfaction of the bill or otherwise refunded. Furthermore, a refund by offset is recognized by both the courts and the Commissioner as the full equivalent of a cash refund. *Commissioner v. Hansen*, 360 U.S. 446, 465-466 (1959); *Illinois Power Co. v. Commissioner*, 792 F.2d 683 (1986); *American Telephone and Telegraph Co. v. Commissioner*, 55 T.C.M. (CCH) 16, 21 (1988).[16] In Rev. Rul. 72-519, 1972-2 C.B. 32 (Situation 2), the Commissioner analyzed a fact situation involving a nontaxable deposit securing property rights which was refundable either in cash or by offset on bills generated from the sale of goods. The Commissioner ruled that the possibility of such an offset did not make the deposits advance payments of those bills. Consistent with this earlier ruling position, the Commissioner basically concedes the equivalence of the two refund methods in the present case. (Pet. Br. 31-32).

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[16]*See also* Rev. Rul. 77-56, 1977-1 C.B. 135 (purchaser's obligation to pay the total installment price is fixed whether satisfied by payment or by offset of a future obligation); Prop. Reg. § 1.7872-2(a)(1) (an amount will be treated as a loan under § 7872 of the Code even though it is agreed that repayment will be accomplished by applying it against the lender's obligation to the borrower).

The Commissioner's approach is tantamount to taxing a bank on the receipt of a customer's bank deposit simply because the same customer might be simultaneously indebted to the bank for taxable service charges or for a loan on which the bank will later collect interest that it must include in income. The parallel becomes even clearer in a case where the bank customer is required to make the deposit as a "compensating bank balance," which under state law would act as security for the loan, including accrued interest,[17] and would be subject to setoff by the bank in case of a default on the loan.[18] In fact, receipt of the bank deposit would not be treated as income to the bank merely because the bank was entitled to receive taxable service charges or interest payments on a loan secured by the bank deposits. Similarly, the receipt of a refundable customer deposit by IPL should not be treated as income merely because, it was entitled to receive separate utility bill payments. As the Seventh Circuit held, the mere fact that one party owes a debt to a another party to whom he provides taxable services does not justify collapsing the two arrangements. (Pet. App. 16a).

[17] *See Thompson v. Hazelwood Savings & Trust Co.*, 234 Pa. 452, 83 A. 284 (1912); *Zimeri v. Citizens & Southern International Bank of New Orleans*, 664 F.2d 952 (5th Cir. 1981). *See generally In re Peabody*, 51 Bankr. 157 (D. Maine, 1985) (Article 9 security interest can be created in a bank account.); 5A *Banks and Banking*, Ch. 9, § 101 (1983) (a bank and its depositor may agree that the funds remain on deposit as security for a loan).

[18] *First National Bank of Martinsville v. American Fletcher National Bank and Trust Co.*, 480 N.E.2d 964, 966 (Ind. App. 1985); *Citizens National Bank of Whitley County v. Mid-States Development Co., Inc.*, 177 Ind App. 548, 380 N.E.2d 1243, 1248-49, n.8 (1978).

3. There Is No Relevant Difference Between a Deposit Securing Future Utility Bills and a Deposit Securing Property Interests.

There is no reason to require a different tax treatment of a bona fide deposit which secures payment of a future utility bill and one which secures some other contractual right, such as avoidance of damages to leased premises. In both cases, the deposit is refundable unless the conduct being secured against occurs. The deposit holder in each case has the same offsetting refund obligation that precludes any increase in his net worth.

Indeed, the parallel between the two situations is particularly clear in the present case because here the utility security deposit secures an asset -- an account receivable -- just as a typical property damage deposit secures tangible assets. The Commissioner tries to distinguish a utility deposit from a damage-type deposit by repeatedly describing the former as a "deposit to secure future income . . ." (*See e.g.* Pet. Br. 21). That erroneous characterization discloses a fundamental flaw in the Commissioner's analysis. The deposits themselves will never become gross income, even upon default by the customer.

Under its accrual method of accounting, IPL recognized income upon reading the customer's meter and determining the amount of electrical usage.[19] A bill was mailed to the customer the next day. (R. 32, 64-65). Thus, the deposit secured the payment of a receivable, a property right. The income itself was generated separately from the deposit and completely without regard to whether the utility bill was even collected. The deposit was either applied to reduce the loss of an asset, the account receivable, in the event of a customer default or

[19] For taxable years beginning January 1, 1986, § 451(f) of the Code mandates that income from utility services be included in income not later than the year in which the services are provided.

refunded to the customer upon termination of service or other prior establishment of creditworthiness. Thus, there is no meaningful distinction between the deposits in this case and admittedly nontaxable deposits securing other forms of property rights.

The result of including the deposit in income at the time of collection would be to double count the income for the applicable time period. IPL would be taxed on the receipt of the deposit and also on the sale of electricity as transmitted to customers and billed for that period. Only at the time of a deposit's refund would IPL be allowed to reverse the earlier double counting through a deduction. The unfavorable timing of this reversing entry underscores the distortion and unreasonableness of the results produced by the Commissioner's arbitrary *per se* rule. (The "double counting" phenomenon is analyzed at Section C of the Telephone Companies' Amicus Brief).

4. An "Economic Benefit" Analysis Is of No Practical Assistance in Resolving This Case.

The authors of a recent article cited by the Commissioner (Pet. Br. 20, 22) find merit in approaching the customer deposits controversy by focusing on the "economic benefit" derived from holding a deposit. J. Burke and M. Friel, *Recent Development in the Income Taxation of Individuals; Tax Free Security: Reflections on Indianapolis Power & Light*, 12 REV. TAX'N INDIVIDUALS 157 (1988). However, in the end, the authors acknowledge the impracticality of the economic-benefit approach, noting that "an economic-benefit test has not been adopted, and it is unlikely that such an approach will be pursued by the Service or the courts." *Id.* at 174.

It is clear that taxing the receipt of the deposit simply because it appears to provide the utility with some unquantifiable economic benefit is not an appropriate basis on which to resolve the issue in this case. While conceptualizing income as equivalent to economic benefit may have appeal to economists, this academic approach is utterly unworkable in practice in light of the fact that all voluntary transactions confer some economic benefit on both transacting parties. *See* R. Posner, *Economic Analysis of Law* 12, 13 (3rd ed. 1986). As stated in *Illinois Power Co. v. Commissioner*, 792 F.2d 683 (7th Cir. 1986):

> In a world without administrative costs the issue whether a receipt that may have to be repaid is income would be elided. The court would merely ask what the (risk-adjusted) present value of the receipt was given the probability that it might have to be returned to the payor and the terms and conditions under which the recipient could use the money in the meantime, and the tax would be levied on that value. But this is not the method used; usually the court just asks how likely is repayment, and if the answer is, not very, the receipt is treated as income.

792 F.2d at 690. Conversely, of course, if the "repayment" is "likely," the tax laws do not treat the receipt as income.

The only reasonable conclusion that can be drawn from economic analysis is that it is not possible to equate a refundable deposit securing future utility bills with the present payment of those bills. The offsetting obligation to repay under circumstances within the customer's unilateral control eliminates any accretion in the utility's net wealth on which it should legitimately be taxed.

III. The Commissioner's *Per Se* Rule Is Arbitrary, Would Not Achieve the Supposed "Benefits" of Avoiding a "Facts and Circumstances" Analysis, and Is Fundamentally Inconsistent with the Commissioner's Position in Related Areas.

The Commissioner criticizes the Tax Court for adhering to its traditional approach of "analyzing all of the facts and circumstances surrounding a deposit to evaluate the rights retained by the depositor and the rights retained by the holder of the deposit." (Pet. App. 34a). Notably, the Commissioner seeks to couple a desire for administrative convenience with a *per se* test that would resolve in the government's favor all cases where the deposit secures future bills. Such an arbitrary rule of thumb has never been enacted by Congress or promulgated as a regulation. As demonstrated above, it would also conflict with both legal precedent and the economic substance underlying utility deposits.

Moreover, utility deposit arrangements are not all the same, and each needs to be scrutinized on its own facts. The Commissioner apparently agrees that the *per se* rule is inadequate in cases where the deposit is escrowed or where the deposit is commingled in a general checking account but the interest payable to the customer must match any interest earned by the utility on the deposited funds. (Pet. Br. 25). However, it is obviously only a facts and circumstances analysis, based on the parties' rights in and control over the deposits, that leads to the correct conclusion in these cases. The *per se* rule would erroneously mandate the opposite conclusion because the deposits in both cases secure future utility bills.

In any event, such an arbitrary rule would not eliminate factual inquiries in the balance of cases. It would still be necessary to examine the facts and circumstances to determine

what is secured by the deposit. The Commissioner's test would simply (and erroneously) exclude from this inquiry those facts that are most indicative of the holder's rights in the deposits and thus are most crucial to resolving whether the payments represent the "accession to wealth" upon which taxability is predicated. *James*, *supra*. An evaluation of the taxpayer's rights in the deposits compared to the customer's is essential in evaluating whether the necessary increase in wealth has occurred. There is no reason to believe that the lower courts are less able to render consistent and principled decisions in the utility deposit area than in the innumerable other areas under the Internal Revenue Code that require a similar fact-based inquiry.[20] In fact, this Court has observed that no one characteristic is decisive in determining whether a given arrangement creates a debt obligation and that the Tax Court is particularly well-suited to make such determinations. *John Kelly Co. v. Commissioner*, 326 U.S. 521, 530-531 (1946). *See also Bauer v. Commissioner*, 748 F.2d 1365 (9th Cir. 1984); *Stinnett's Pontiac Service, Inc. v. Commissioner*, 730 F.2d 634 (11th Cir. 1984); and *Dunn v. Commissioner*, 615 F.2d 579 (2d Cir. 1980).

It is instructive that the Commissioner does not hesitate to apply a facts and circumstances test to distinguish between deposits and advance payments when he determines that it works to his advantage. For example, it is often necessary to determine whether a current-year payment by a livestock producer to a feed dealer constitutes a deductible prepayment for the purchase of feed or a nondeductible deposit. The Commissioner sets forth the applicable test as follows:

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[20] *See* E. Seago, *Recent Cases Focus on When Deposits Are Includible in Income*, 70 J. TAX'N 38 (1989).

> *Whether a particular expenditure is a deposit or a payment depends on the facts and circumstances of each case.* When it can be shown that the expenditure is not refundable and is made pursuant to an enforceable sales contract, it will not be considered a deposit. The following factors, although not all inclusive, are indicative of a deposit rather than a payment: the absence of specific quantity terms; the right to a refund of any unapplied payment credit at the termination of the contract; the treatment of the expenditure as a deposit by the seller; and the right to substitute other goods or products for the feed ingredients specified in the contract.

Rev. Rul. 79-229, 1979-2 C.B. 210 (emphasis added) (citation omitted).[21]

The courts have also applied these factors in distinguishing customer deposits and advance payments from the standpoint of the payor. As stated in *Keller v. Commissioner*, 79 T.C. 7 (1982), *aff'd*, 725 F.2d 1173 (8th Cir. 1984), dealing with payments to a drilling contractor:

> The term 'payment' has a special meaning for tax purposes. It does not mean a simple transfer of money by a taxpayer. A transfer of money pursuant to a binding contract also is not enough. A payment occurs only when the taxpayer's money is 'irretrievably out of pocket.'

[21] Application of that test to the analogous facts in the present case shows that the deposits here are not advance payments. *See*, *supra*, pages 14-15.

> If, by express, implied, or customary terms, a taxpayer retains a unilateral power, to get the money back, then the money transfer is a 'deposit' rather than a payment.

79 T.C. at 29 (citations omitted).

Similarly, in a case dealing with payments made by a farmer to a fertilizer seller, the court observed:

> The question was whether the taxpayer had, at the time of payment, irrevocably committed himself to the purchase of specific items within a specific year.

Schenk v. Commissioner, 686 F.2d 315, 319 n.22 (5th Cir. 1982).

The definition of a deposit adopted by the Commissioner in Rev. Rul. 79-229 is consistent with the controlling precedent discussed above and with the lower courts' decisions in this case, *i.e.* a true deposit is an amount that is refundable to the customer and is not remitted as contractual consideration for enforceable rights to acquire designated goods or services. However, the Commissioner wishes to reserve this latter method of distinguishing deposits from advance payments only for situations where it apparently works to his benefit. Consistency, economic reality, and prior precedent all require that a similar facts and circumstances test be applied in all cases. When that is done, it is clear that the customer deposits here should be classified as true security deposits and not as prepayments for services.

CONCLUSION

The Seventh Circuit Court of Appeals' decision should be affirmed because it correctly holds that refundable security deposits of the type collected by IPL are not includible in income under controlling precedents of this Court and a realistic analysis of the deposits' purpose and economic effect.

Respectfully submitted.

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REPLY

BRIEF

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In the Supreme Court of the United States

OCTOBER TERM, 1989

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

INDIANAPOLIS POWER AND LIGHT COMPANY

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

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1. The thrust of respondent's argument is that security deposits to guarantee the payment of future utility bills cannot be income because they are not " 'accessions to wealth, clearly realized, and over which the taxpayers have complete dominion' " (Br. 10, quoting *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955)). It is undisputed that respondent had complete dominion and control over the deposits, and it is clear that any income was "realized" when it was received in cash. Thus, respondent's argument is that the receipt of the deposit is not an "accession to wealth" because it was "unequivocal[ly]" (Br. 22) or "unconditionally subject to refund" (Br. 19)—either directly or by applying the amount of the deposit to a future bill for services—or, alternatively, was subject to refund upon the satisfaction by the customer of certain conditions. See Resp. Br. 9-13, 24-30. Hence, respondent

concludes that the deposit should be viewed as the property of the customer until it is applied to an outstanding bill. This analysis is flawed. Rather, as we explained in our opening brief, the cash receipt of a deposit that is designed to secure the payment of future bills for utility services, and eventually to be applied to satisfy outstanding bills, is an "accession to wealth" in precisely the same way as any other advance payment for goods or services, and it should be taxed accordingly.

Respondent's position ultimately rests on semantics that should not be determinative of the correct tax treatment. This can be illustrated by comparing two arrangements that a landlord might make to ensure full payment of rent. He could require the tenant to deposit one month's rent in advance with the proviso that the deposit would be returned when the full year's rent has been paid. Alternatively, he could require the tenant to pay the same sum in advance to be applied later as payment of the last month's rent after the tenant has paid the first 11 months' rent. Respondent's position appears to be that these two essentially identical arrangements should receive different tax treatment—the first is a refundable deposit that is not taxable as income upon receipt and the second is an advance payment that is taxable as income upon receipt.[1] See Resp.

[1] Respondent specifically concedes that if the deposit is described as securing the last month's rent, it is taxable upon receipt, even though it is designated as a security deposit (Br. 26-27). Respondent explains that this is because in that situation, "the landlord's duty to refund does not arise until he has received payment of the agreed month's rent, *i.e.*, he does not divest himself of the cash until he receives an identical amount of cash" (Br. 27). It is not apparent why this observation is not equally applicable to—and controlling in—the instant case. Respondent is not obliged to make a refund until the customer makes the agreed payments establishing his creditworthiness or terminates service.

Br. 17-19, 24-30. There is no sound basis for such disparate treatment.

In fact, respondent's own theory is difficult to square with that result. In arguing that security deposits are unconditionally refundable, respondent maintains that applying a deposit to satisfy a bill is "the full equivalent of a cash refund" (Br. 29). See also Wisconsin Electric Power Co., et al. Amicus Br. 11 & n.2. If so, then there is no justification for treating the case of a payment that is to be refunded after 12 months any differently from the case of a payment that is to be applied to the last month's rent. In both cases, the recipient of the payment recognizes the obligation to "refund" it later—perhaps in the form of a credit for services rendered to the payor—and therefore, under respondent's view, the payment cannot be income upon receipt. The difficulty with this approach is that it is squarely contrary to the now settled principles laid down by this Court, which make an advance payment of the last month's rent taxable upon receipt. Indeed, almost any advance payment can be regarded as "refundable" under respondent's analysis because the payment ultimately will be applied to satisfy the customer's obligation for goods or services to be provided in the future, yet advance payments are nonetheless taxable upon receipt.

Respondent's approach is flawed theoretically by its assumption that a payment cannot be income if the recipient has some obligation to repay it.[2] In a case like this,

[2] Contrary to respondent's submission (Br. 10-11), this assumption is not supported by *James* v. *United States*, 366 U.S. 213, 219 (1961). The Court held in *James* that the proceeds of an embezzlement must be reported as income, explaining that the receipt of funds without restriction as to their use or recognition of an obligation to repay must be income. The absence of recognition of an obligation to repay was critical in *James* because recognition of such an obligation in that context would have meant that the embezzler did not hold the funds as

where the taxpayer receives a payment representing an income item and subject to his unfettered use and control, it is appropriate to recognize the income upon receipt, even though there is a contingent obligation to refund the money at some future time. As we note in our opening brief (at 21), the utility's contemplation at the time the deposit is paid is that it will be applied to an outstanding bill as payment for goods or services, not directly refunded; otherwise, the deposit would not be required in the first place. There is no fixed obligation to repay the funds.

On the facts here, respondent's obligation to refund the deposit is a contingent one that turns on several conditions, and it is uncertain when the obligation will have to be fulfilled. For instance, the deposit may have to be refunded or applied to the customer's bill within a few months if he quickly terminates service; or it may be refunded in nine months to a year if he immediately establishes a good payment record; or it may be held for a much longer time if the customer maintains an erratic payment record; or, if the deposit goes unclaimed and ultimately escheats to the state, it will be held by respondent for more than seven years. For this entire, indefinite period during which the conditions for refund of the deposit or its application to the customer's bill have not been satisfied, respondent has full ownership and unrestricted use of the funds. It is not appropriate for respondent to defer recognition of income in the amount of the deposit for many months or years, simply because at some time the money will be credited against a bill or refunded (in conjunction with an equal payment by the

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his own. That is not true here or in other contexts involving advance payments for goods or services, however, and the Court in *James* did not suggest that the existence of an obligation to repay in these circumstances would be inconsistent with treating a payment as income upon receipt.

customer for goods or services). The more sensible and accurate tax treatment is to treat the deposit as income when it is received—when it becomes respondent's property subject to its full control and is indistinguishable from any other form of advance payment for future goods or services—and then to allow a deduction in the future if the deposit is ever refunded.

Contrary to respondent's assertion (Br. 24), the deposits at issue here are not correctly viewed as loans. A loan, which involves a promise to repay the principal, is an example of a cash payment that does not give rise to income upon receipt, but not every payment that is subject to a refund obligation is necessarily a loan. A loan, almost by definition, does not give rise to income. It is a self-contained transaction in which money changes hands for a period of time and is then repaid. Apart from the interest paid, the parties are in the same position at the end as when they started, and no income has been generated. By contrast, the deposits at issue here are to facilitate the production of income through the payment of bills for utility services; in the end, the utility has received income either through direct application of the deposit to an outstanding bill or by a separate payment from the customer that is required in order to permit refund of the deposit.[3]

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[3] Thus, there is no merit to respondent's attempt to distinguish these deposits from advance payments, and to equate them with loans, on the basis of their connection with the provision of goods or services. See Resp. Br. 12-13, 24-26. While there may not be the same kind of contractual connection between the deposit and a specific good or service to be provided in the future that exists in the case of an ordinary advance payment, it is manifest that the deposit is part and parcel of a larger transaction in which the recipient provides utility services in exchange for money. Without the promise and expectation of future utility services, the deposit would never be paid. Thus, the utility deposit is not materially distinguishable from an advance payment "exchange[d]" for a "promise[] to provide goods or services"

Thus, the deposit operates like an advance payment—in the words of Judge Sneed, it "*must* result in income either at the time of receipt, the time of performance, or both" (J. Sneed, *The Configurations of Gross Income* 50 (1967)). In contrast to a true loan, which is never recognized as income, the only question in the case of a deposit to secure the payment of future income is *when* should the amount of the deposit be recognized as income.[4] The economic reality of the situation and this Court's decisions in the advance payment cases dictate the conclusion that it is appropriate to recognize the amount of the deposit as income when received.

2. Respondent argues (Br. 20 n.9, 31-32; see also American Information Technologies Corp., et al. (Telephone Companies) Amicus Br. 5-8, 10-12) that the inclusion in income of a deposit to secure the payment of future utility bills leads to double counting in the case of

(Resp. Br. 12), and it is quite distinct from a loan, which is a self-contained transaction that has no connection with the provision of goods or services separate from the loan itself.

[4] Respondent's effort to equate utility deposits with ordinary or "compensating balance" bank customer deposits (Br. 30) is also flawed. It is undisputed in this case that the utility deposits are placed within the unfettered control of the utility when received; the funds become the utility's property at that time. The only question is whether they should nevertheless not be included in income until later because of the utility's obligation at some future time to refund or otherwise account for the amounts deposited. By contrast, the funds deposited in a customer's bank account clearly remain his property and are not within the unfettered control of the bank. While a bank has the power to invest funds that customers keep on deposit, that power is heavily regulated, and its use of the funds is clearly restricted. In sum, in contrast to a utility's control over customer deposits, a bank does not have ownership of or "complete dominion" (*Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. at 431) over funds that its customers keep on deposit, and hence the amounts deposited are not income to the bank.

accrual-basis taxpayers. This argument is mistaken. The overcounting identified by respondent is inherent in the accrual method and will inevitably occur when a customer fails to pay a bill that has been accrued by the seller as income (see, *e.g.*, *Commissioner* v. *Hansen*, 360 U.S. 446, 466-467 (1959)); the phenomenon has nothing to do with the Commissioner's proposed treatment of deposits.

That the government's position does not create double counting is illustrated by the very example used by respondent (see Telephone Companies Amicus Br. 11-12). The customer makes a $50 deposit and is billed for $50 worth of service in November and December. Under the Commissioner's approach, the utility recognizes $100 in income in the first year, though it has provided only $50 worth of service. If the customer defaults on the payment of the November-December charges, the deposit is applied to his bill in January and the utility is entitled to a $50 deduction in the second year. It would appear at first glance, as respondent asserts, that $50 in income has been incorrectly shifted into the first year. But this "income shifting" is a direct result of the accrual of the November-December bill before it is paid; it has nothing to do with the treatment of the deposit. If the hypothetical is altered slightly to remove the deposit feature, we see that the same $50 income shift occurs. The taxpayer accrues $50 in income in the first year as a consequence of its billing for November-December charges, even though it receives no actual income in that year. When the customer defaults in the second year, the utility is entitled to a $50 deduction to reflect the fact that it never received the income that it had accrued in the first year.

Respondent's attempt to lay the blame for this income shift at the doorstep of the Commissioner's treatment of the deposit is flawed because respondent is commingling two distinct concepts and two different utility bills. Under

principles of accrual accounting, a taxpayer accrues income when all the events have occurred that establish its right to receive that income—for example, when it has provided services—even though it has not yet received cash payment. See generally *United States* v. *General Dynamics Corp.*, 481 U.S. 239 (1987). For that reason, in respondent's example the utility accrues income for the November-December services before payment is made, and therefore it is entitled to an adjustment when the customer later fails to pay.

Advance payments, on the other hand, must be taken into income when they are received (whether the recipient is on the cash or the accrual method), even though the goods or services for which the payment is made may not be furnished until the following year. Thus, the treatment of advance payments demands the inclusion in income of amounts that have not yet been earned by performance. That treatment is required by this Court's decisions in *Schlude* v. *Commissioner*, 372 U.S. 128 (1963); *American Automobile Ass'n* v. *United States*, 367 U.S. 687 (1961); and *Automobile Club* v. *Commissioner*, 353 U.S. 180 (1957); and respondent does not challenge the correctness of these decisions. See generally 4 B. Bittker, *Federal Taxation of Income, Estates and Gifts* ¶ 105.3.4, at 105-60 to 106-64 (1981); Gov't Br. 12-13; see also *RCA Corp.* v. *United States*, 644 F.2d 881, 887-888 (2d Cir. 1981), cert. denied, 457 U.S. 1133 (1982). Under this well-settled rule, treating the deposits here as advance payments means that they are included in income when received, even though the utility bills to which they ultimately will be applied are for services to be rendered at some future time, many months or perhaps years after receipt of the payments. This is why, in respondent's example, the recognition of income in the amount of the deposit does not relate to any services that have already been provided by the utility.

The recognized income relates to the services to be rendered in the future period to which the deposit is applied (either after termination or after the customer demonstrates his creditworthiness), and this is equally true whether the taxpayer reports on the cash or accrual method. In sum, the Commissioner's treatment of deposits held by accrual-basis taxpayers does not introduce any double counting or other distortion of income.[5]

3. Citing Rev. Rul. 79-229, 1979-2 C.B. 210, and two court decisions, respondent argues (Br. 34-37) that the Commissioner seeks to apply a double standard by denying the payor a deduction for cash prepayments where he would require the recipient to include the payment in income upon receipt. But respondent fails to acknowledge that the ruling and the cited cases are directed at the possibility of "taxpayer abuse" by a cash basis taxpayer's accelerating his deductions into an earlier year by means of a year-end cash transfer. See *Keller* v. *Commissioner*, 79 T.C. 7, 29, aff'd, 725 F.2d 1173 (8th Cir. 1984). Under the cited authority, the acceleration of the deduction in this manner will not be allowed where the prepayment is made for a tax advantage, not for a valid business purpose.

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[5] Respondent's argument (see Br. 7, 31-32) that the deposits here should not be viewed as securing future "income" because it is an accrual-basis taxpayer is wholly without merit. There can be little doubt that the "income" upon which respondent pays income tax is composed of the amounts paid by its customers in exchange for utility services. The deposits are applied to customer accounts as such payments for services, and therefore they are income in the same way as other customer bill payments. The fact that respondent's accrual accounting system makes an income entry when the bill is sent and reduces the "accounts receivable" entry when the bill is paid is a matter of bookkeeping, which is significant to the timing of income recognition but does not alter the fundamental truth that it is the payments, not the bills, that generate income to respondent.

This problem of manipulation by the payor of prepayments to achieve a deduction in an earlier year is distinct from the problem presented here regarding the time at which the recipient of a payment must take it into income, and the tax treatment from the two perspectives is not necessarily the same. The situations involved in Rev. Rul. 79-229 and the cited cases have nothing to do with the "security" concerns that respondent believes must be controlling here; for example, in *Schenk* v. *Commissioner*, 686 F.2d 315 (5th Cir. 1982), the payment in question was not requested by the supplier and the payor received no benefit (other than the claimed tax deduction) for making it in advance. Respondent presumably would not dispute that such "nonsecurity" payments must be regarded by the recipient as advance payments that are recognized as income upon receipt, but these payments nonetheless may not be immediately deductible by the payor if they serve no purpose other than to obtain a tax advantage.

4. In our opening brief (at 24-34), we argue that the "facts and circumstances" test does not provide a reasoned basis for deciding advance deposit cases because the factors relied upon by the Seventh Circuit (almost exclusively interest) and by the Tax Court have little bearing on the correct treatment of a customer deposit. Respondent does not address the particulars of this argument, and does not explain why the presence or absence of certain facts should affect the taxability of individual utility deposits. Indeed, the inconsistent approaches taken by the various briefs filed in this case highlight the amorphousness and unworkability of the "facts and circumstances" test invoked by the courts below.[6] In contrast to the unpredictable and erratic

[6] Respondent simply states that each case should turn on its own facts and circumstances and asserts that the circumstances of this case justify deferral of the receipt of income until the deposit is applied to a particular bill. To justify this conclusion, respondent lists the factors upon which the courts below relied without responding to the Commissioner's objections to the relevance of those factors. Br. 14-16. See also Wisconsin Power Amicus Br. 8, 16 n.4. With respect to interest, respondent states, without explanation, that it is a "significant factor" in the context of regulated public utilities. See Resp. Br. 19-23. Amicus El Paso Electric Co. argues (Br. 18-19) that the existence of an interest obligation reflects a restriction on the utility's ability to use the money that is necessarily inconsistent with treating the deposit as an advance payment. Amicus Oak Industries, Inc., on the other hand, maintains that the presence or absence of an interest obligation is completely irrelevant (Br. 8-13). Amicus Oak Industries also argues that the Tax Court erred in relying on any factor other than "respondent's control over the ultimate disposition of the deposits" (Br. 13). The *ad hoc* and essentially standardless nature of the "facts and circumstances" test is tellingly reflected in the brief of Amicus American Information Technologies Corp. (at 14), which simply describes some of the features of this case and announces without further explanation that these facts, considered in combination, should result in the deferral of income until the deposit is applied.

results that are invited by the "facts and circumstances" test, the Commissioner's approach of treating cash deposits to secure the payment of future bills as income upon receipt provides a basis for consistent decisionmaking that is soundly based in settled principles under the Code regarding the treatment of advance payments. Indeed, even if it would be within the Commissioner's discretion under the Code to rule to the contrary, the position he has taken in Rev. Rul. 72-519, 1972-2 C.B. 32, is well within his authority to choose among reasonable interpretations of the congressional mandate and to assure that taxpayers' accounting methods accurately reflect income. See, *e.g.*, *National Muffler Dealers Ass'n* v. *United States*, 440 U.S. 472, 488-489 (1979); *Commissioner* v. *Hansen*, 360 U.S. at 467.[7]

[7] Respondent repeatedly suggests (Br. 3, 23) that the Commissioner's position with regard to utility deposits represents a reversal of 50 years

For the foregoing reasons, and those stated in our opening brief, the judgment of the court of appeals should be reversed.

Respectfully submitted.

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Solicitor General

SEPTEMBER 1989

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of administrative practice that did not challenge respondent's method of reporting these deposits. In fact, there has been no change in position by the Commissioner. Respondent neglects to mention that the advance payment cases upon which the Commissioner's published ruling is based were not decided until only a few years before Rev. Rul. 72-519 was issued in 1972. Until the treatment of advance payments was settled by those cases, culminating with the decision in *Schlude* v. *Commissioner*, *supra*, in 1963, there was no occasion for the Commissioner to consider the effect of those decisions upon the treatment of utility deposits.

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On Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

BRIEF OF AMICUS CURIAE EL PASO ELECTRIC COMPANY IN SUPPORT OF RESPONDENT

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No. 88-1319

IN THE

Supreme Court of the United States

OCTOBER TERM, 1988

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

INDIANAPOLIS POWER & LIGHT COMPANY,
Respondent.

On Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

BRIEF OF AMICUS CURIAE EL PASO ELECTRIC COMPANY IN SUPPORT OF RESPONDENT*

THE INTEREST OF AMICUS CURIAE

The El Paso Electric Company ("El Paso") is the Plaintiff in a case now pending before the United States Claims Court, *El Paso Electric Company v. United States*, No. 412-86T. A major issue in that case is whether refundable security deposits required from certain non-creditworthy customers are income to El Paso upon receipt.

El Paso is a regulated public utility incorporated under the laws of the State of Texas with its principal

* Both Petitioner and Respondent have consented to the filing of this brief, and the written consents are on file with the Clerk. The opinion below is reported at 857 F.2d 1162 (7th Cir. 1988).

place of business in El Paso, Texas. Its principal business activity is the generation, transmission, distribution, and sale of electric energy. El Paso serves approximately 230,000 customers in the Rio Grande Valley of West Texas and South-Central New Mexico in a service area covering approximately 10,000 square miles and containing an estimated population of 724,000. Its major franchises are with the cities of El Paso, Texas and Las Cruces, New Mexico.

As an electric public utility operating in Texas and New Mexico, El Paso is subject to the laws of both states, including the rules, regulations, and orders promulgated and issued by the regulatory bodies of both states. Both the Public Utility Commission of Texas and New Mexico Public Service Commission have promulgated rules and regulations concerning the collection, retention, and refunding of deposits by electric public utilities.

Consistent with the respective statutory and regulatory provisions, El Paso's long-standing policy and practice has been, since approximately 1910, to require a deposit as security for the payment of a portion of bills for electric service from new or existing customers who have failed to either establish or demonstrate creditworthiness. Historically, deposits have been required from approximately fifteen percent of the customer base. Each depositor is issued a receipt and separate accounting records are maintained for each deposit; El Paso pays interest of six percent per anum on all deposits from the date of deposit; the right of El Paso to any part of a deposit is not fixed and cannot be determined when the deposit is made; the customer-depositor controls the timing and disposition of the deposit; and unclaimed deposits escheat to the respective states. The security deposit program is intended to prevent or minimize losses attributable to credit-risk customers which all customers would otherwise bear in the form of higher rates for electric service. Because interest is paid on all customer security deposits, it would not be economically prudent to collect and hold deposits from those creditworthy customers who timely pay their bills for electric service. The higher interest and corresponding administrative costs of such a policy would result in unnecessarily high electric service rates for all customers.

El Paso, an accrual basis taxpayer, has always treated customer security deposits as a current liability for financial, regulatory, and tax reporting purposes and has not treated the receipt of such deposits as gross income for any purpose. However, the Internal Revenue Service, on audit of the taxable years 1974 through 1978, determined that deposits received from customers were includible in gross income in the year of receipt as advance payments of income. El Paso paid the resulting deficiency, filed claims for refund, and timely filed suit in the United States Claims Court for the refund of the tax paid. The Government's discovery in the Claims Court case is almost complete, and the trial on the customer deposit issue has been tentatively postponed pending this Court's decision in this case.

If this Court should reverse the judgment below, that reversal would adversely affect El Paso's refund suit on this issue. If this Court instead affirms the judgment below, holding that customer deposits subject to an unconditional refund obligation and burdened with an interest requirement constitute nontaxable security deposits, El Paso will be given the opportunity to prove that its customer deposits constitute nontaxable security

deposits and, if it carries that burden successfully, to exclude such deposits from gross income in the respective years of receipt.

SUMMARY OF ARGUMENT

Under the governing principles of income recognition derived from decisions of this Court, it is clear that a taxable gain is predicated on the existence of a gain, profit or "accession to wealth," which can be determined only from the consideration of all the relevant facts and circumstances. The Tax Court and Seventh Circuit, consistent with that principle, correctly applied a "facts and circumstances" test in this case to evaluate the attendant rights and obligations surrounding the customer deposits collected by respondent Indianapolis Power & Light Company ("IPL"), and correctly determined thereunder that the customer deposits in this case constitute nontaxable security deposits. In contrast, the standard proposed by the Commissioner arbitrarily classifies IPL's customer deposits as advance payments of income solely on the basis of the income interest secured by the deposits, regardless of any other fact or circumstance. The Commissioner's approach, which was adopted by the Eleventh Circuit in *City Gas Co. v. Commissioner*, 689 F.2d 943 (11th Cir. 1982) ("City Gas II"), incorrectly excludes from consideration an evaluation of those facts and circumstances concerning the attendant rights and obligations which are material to the issue of the existence of a taxable gain. Accordingly, both the Tax Court and Seventh Circuit properly rejected the Commissioner's test.

The Commissioner correctly does not assert that IPL's customer deposits are advance payments of income but nevertheless contends that they are "essentially the

same thing" (Pet. Br. 30) and "should be regarded as advance payments and taxed as such" (Pet. Br. 24). However, the principles of governing law do not support such a conclusion where at the time of receipt the taxpayer lacks any present and fixed right to unfettered dominion and control over customer deposits that are subject to both an interest and unconditional refund obligation. The error of the Commissioner's "equivalency" contention is demonstrated by the application of the "per se" rule in this case which arbitrarily classifies as advance payments of income all deposits which secure only income related interests and, therefore, fails to consider the attendant rights and obligations surrounding the deposits that are relevant to the issue of taxable gain.

The Commissioner erroneously assumes as support for his "equivalency" contention that the "functional similarity" and "economic reality" of IPL's customer deposits are equivalent to that of advance payments of income. However, the Seventh Circuit correctly recognized the substantive similarity between a deposit that secures income and a deposit that secures property, the latter being generally considered analogous to a loan because of the offsetting legal obligation to repay the deposit, and which the Commissioner agrees is a nontaxable security deposit. Although an offsetting legal obligation to repay the deposit exists in both cases, IPL, unlike the recipient of a typical property deposit, is also required to pay interest on a customer deposit. Accordingly, the existence of IPL's interest obligation, together with the offsetting legal obligation to repay a customer deposit, demonstrate that the "economic reality" of the customer deposits in this case is analogous to a loan.

The "primary purpose" test adopted by both the Commissioner and Eleventh Circuit will foster disparate treatment and operate in a discriminatory fashion against the utility industry and other taxpayers who, because of the nature of their business, have few non-income-producing interests that can be the subject of a deposit. In cases involving "mixed" deposits, the test will allow taxpayers to structure their deposit transactions so that they will qualify as security deposits by simply providing in the agreement that the majority of the items secured by the deposit are non-income-producing interests. Also, in cases where the deposit secures an income interest, but only one or no property type interests, the outcome-determinative bias of the test operates to classify the deposit as an advance payment of income. Since utilities generally have few nonincome-producing interests (e.g. meters) that could be the subject of a deposit, the secured income-producing interest will almost certainly be deemed the "primary purpose". *See* Rev. Rul. 72-519, 1972-2 C.B. 32, 33 (Situation 2). Both of the problems inherent in the application of the Commissioner's "primary purpose" test are avoided under the traditional facts and circumstances approach applied by both the Tax Court and Seventh Circuit which properly evaluates all attendant rights and obligations rather than focusing on the nominal nature of the secured interests.

ARGUMENT

RESPONDENT'S CUSTOMER DEPOSITS CONSTITUTE NONTAXABLE SECURITY DEPOSITS AND ARE THEREFORE PROPERLY EXCLUDED FROM GROSS INCOME IN THE YEAR OF RECEIPT

A. The proper test to distinguish nontaxable security deposits from taxable advance payments of income requires the consideration of all the relevant facts and circumstances to evaluate the attendant rights and obligations

It is well settled that "accessions to wealth" constitute taxable gain, *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955), and that the determination of taxable gain is conditioned upon the presence of rights and absence of obligations. *See, e.g., Commissioner v. Wilcox*, 327 U.S. 404, 407-408 (1946). Thus, it has generally been held that a security deposit which is subject to a refund obligation is not taxable upon receipt. *See, e.g., Clinton Hotel Realty Corp. v. Commissioner*, 128 F.2d 968 (5th Cir. 1942); *Mantell v. Commissioner*, 17 T.C. 1143 (1952).

However, both the Commissioner and Eleventh Circuit have formulated a test which classifies deposit payments either as a taxable advance payment of income or as a nontaxable security deposit on the basis of whether the deposit secures the performance of income or non-income producing covenants, regardless of the attendant rights and obligations.[1] Under this test, the

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[1] In Rev. Rul. 72-519, 1972-2 C.B. 32, the Commissioner's test is set forth as follows:

> That is, when the purpose of the deposit is to guarantee the customer's payment of amounts owed to the creditor, such a

nature of the interest secured by the deposit is outcome-determinative of classification for tax purposes; deposits which secure only the performance of income-producing covenants are "per se" taxable advance payments, and those deposits which secure only nonincome-producing covenants are "per se" nontaxable security deposits.[2]

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deposit is treated as an advance payment, but when the purpose of the deposit is to secure a property interest of the taxpayer the deposit is regarded as a true security deposit. *Id.* at 33.

Similarly, the view of the Eleventh Circuit in *City Gas Co. v. Commissioner*, 689 F.2d 943 (11th Cir. 1982) ("City Gas II") is described as follows:

> The issue is whether the sums were intended to be applied to discharge payment for income items (e.g., the total month's bill for gas, or for turn-on and turn-off charges or other charges for services), or on the other hand were intended to secure performance of nonincome-producing covenants (e.g., damage to meters). *Id.* at 946.

The Commissioner acknowledges that the two tests are essentially identical:

> The Eleventh Circuit, in *City Gas Co. v. Commissioner*, 689 F.2d 943 (1982), approved the Commissioner's approach to the question of including utility customer deposits in income. (Pet. Br. 15-16).
>
> • • •
>
> The position taken by the Commissioner in Rev. Rul. 72-519 and approved by the Eleventh Circuit in *City Gas* — namely, that a deposit to secure payments that will be due in the future after goods or services are provided is equivalent to an advance payment. . . . (Pet. Br. 16).

[2] In the case of a "mixed" or "dual-pupose" deposit, where there are both income and nonincome-producing covenants, both the Commissioner and Eleventh Circuit apply a "primary purpose" test to determine whether the deposit is to be classified either as an advance payment of income or as a security deposit. The Eleventh Circuit's "mixed-purpose" test as formulated in *City Gas Co. v. Commissioner*, 689 F.2d 943 (11th Cir. 1982) ("City Gas II") is set forth as follows:

> [t]he test to be applied in this case is whether, under all the circumstances, the primary purpose of the payments at issue was a prepayment of income items, or whether the primary purpose was to secure the performance of nonincome-producing covenants. *Id.* at 948.

Neither the Commissioner nor the Eleventh Circuit have articulated the specific circumstances or factors deemed to be relevant to a determination of "primary purpose." In that regard, it appears that in application the test simply counts the number of each type of interest (income v. nonincome) to determine which of the two types of interests constitute, on a numerical basis, the primary purpose for the deposit. *See*, Rev. Rul 72-519, 1972-2 C.B. 32, 33 ("The fact that Y pays annual interest on the 'deposit' does not *outweigh* its primary characteristics as an advance payment") (emphasis added). Under the primary purpose test, the nature of the interests related to the deposit therefore determines classification as either an advance payment of income or a security deposit, in the same manner as the test classifies deposits which relate solely to either income or nonincome type interests.

The "per se" approach adopted by the Commissioner and Eleventh Circuit conflicts which the principles derived from decisions of this Court which require, as essential to the determination of taxable gain, the consideration of all facts and circumstances to evaluate the attendant rights and obligations.

In *North American Oil Consolidated v. Burnet*, 286 U.S. 417, 424 (1932):

> If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he

> has received income which he is required to return. . . .[3]

In *Spring City Foundry Co. v. Commissioner*, 292 U.S. 182, 184-185 (1934):

> Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the *right* to receive and not the actual receipt that determines the inclusion of the amount in gross income. When the right to receive an amount becomes fixed, the right accrues. (emphasis in original).

In *Commissioner v. Wilcox*, 327 U.S. 404, 407 (1946):

> The very essence of taxable income, as that concept is used in [the predecessor to § 61(a)], is the accrual of some gain, profit or benefit to the taxpayer.
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> • • •
>
> Not every benefit received by a taxpayer from his labor or investment necessarily renders him taxable. Nor is mere dominion over money or property decisive in all cases. In fact, no single, conclusive criterion has yet been found to determine in all situations what is sufficient gain to support the imposition of an income tax. No more can be said in

[3] The Comissioner acknowledges the application of the principles enunciated in *North American Oil Consolidated* to the issue in this case:

> This rule governing the tax treatment of advance payments accords with the "claim of right doctrine," set forth by the Court in *North American Oil Consolidated v. Burnet*, 286 U.S. 417, 424 (1932) (quotation omitted) (Pet. Br. 13 n.5).

> general than that all relevant facts and circumstances must be considered.

And from the same opinion, *id.* at 408:

> [i]t is enough to note that a taxable gain is conditioned upon (1) the presence of a claim of right to the alleged gain and (2) the absence of a definite, unconditional obligation to repay or return that which would otherwise constitute a gain.
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> • • •
>
> Nor can taxable income accrue from the mere receipt of property or money which one is obliged to return or repay to the rightful owner, as in the case of a loan or credit.
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> • • •
>
> But apart from such factors the bare receipt of property or money wholly belonging to another lacks the essential characteristics of a gain or profit within the meaning of [the predecessor to § 61(a)].

In *James v. United States*, 366 U.S. 213, 219 (1961):

> When a taxpayer acquires earnings, lawfully or unlawfully, without the consensual recognition, express or implied, of an obligation to repay and without restriction as to their disposition, "he has received income which he is required to return . . . ." *North American Oil Consolidated v. Burnet, supra.* (286 U.S. at p. 424).
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> This standard . . . excludes loans.

The Tax Court below, consistent with the principles expressed in the decisions of this Court, applied the following standard to determine whether the customer deposits in this case constituted taxable advance payments of income or nontaxable security deposits:

> In our judgment, we should continue to examine all of the facts and circumstances surrounding a deposit to evaluate the rights retained by the depositor and the rights acquired by the holder of the deposit (Pet. App. 34a).

And, as acknowledged by the Seventh Circuit:

> If the deposit is to serve as security, it is properly excluded from income, regardless of whether the future performance it secures is the payment of income for services to customers or merely non-income covenants such as protecting against damage to property (Pet. App. 6a).
>
> • • •
>
> We therefore retain the traditional approach of analyzing the facts and circumstances to determine whether the principal purpose of a deposit is to secure future performance or to serve as an advance payment of income (Pet. App. 16a-17a).

This approach and result accords with general income recognition principles which require consideration of all the facts and circumstances. In contrast, under the standard formulated by both the Commissioner and Eleventh Circuit, which focuses on the nominal nature of the type of interest secured by the deposit, a deposit which secures the payment of future income is taxable

upon receipt regardless of the rights retained by the depositor and the rights acquired by the deposit holder.[4]

Because the "per se" rule adopted by both the Commissioner and Eleventh Circuit arbitrarily classifies as advance payments of income all deposits that secure only the performance of income-producing covenants, both the Tax Court and Seventh Circuit properly rejected that standard in favor of a standard consistent with the principles enunciated by this Court which requires an examination of all relevant facts and circumstances to evaluate the attendant rights and obligations surrounding the deposit.

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[4] The Eleventh Circuit in *City Gas Co. v. Commissioner*, 689 F.2d 943 (11th Cir. 1982) ("City Gas II") stated that its "primary purpose" test is "[c]onsistent with the above former Fifth Circuit precedent . . . ." *Id.* at 947-948. However, none of the three former Fifth Circuit cases reviewed by the Eleventh Circuit can be interpreted as support for a test which conclusively presumes that a deposit which either solely or primarily secures income-producing covenants is necessarily an advance payment of income regardless of any other fact or circumstance. To the contrary, the former Fifth Circuit cases did not view the nature of the interests secured by a deposit to be determinative of whether the deposit constituted a security deposit or an advance payment of income, but instead applied a facts and circumstances approach to evaluate the rights and obligations surrounding the deposit. *See, e.g., Astor Holding Co. v. Commissioner*, 135 F.2d 47, 48 (5th Cir. 1943) ("Whether a payment falls into one category or the other depends on the facts of the particular case."). Accordingly, the "primary purpose" test as formulated by the Eleventh Circuit is not consistent with former Fifth Circuit precedent. Further, no other circuit has adopted a "per se" test which distinguishes between a security deposit and an advance payment of income solely on the nature of the interest secured by the deposit.

B. The customer deposits in this case are not equivalent to advance payments of income

The Commissioner cites (Pet. Br. 12) this Court's "trilogy" of prepaid income decisions[5] as the established law governing the scope and taxation of advance payments of income. Those cases, however, are neither dispositive nor illustrative of the issue in this case because the "trilogy" cases involved materially different facts[6] and presented a different legal question. As recognized by the Tax Court in *City Gas Co. v. Commissioner*, 74 T.C. 386, 395 (1980) ("City Gas I"), "[T]he issue in those ["trilogy"] cases was not, however, whether prepayments were income within the meaning of Section 61(a), but rather, in what year they were includible under tax accounting principles."[7] The issue in this case, however, is whether the customer deposits are income to IPL under Section 61(a).[8] The Commissioner therefore correctly does not assert that the customer deposits in this case are advance payments under the "trilogy" cases decided by this Court, but nevertheless contends

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[5] *Schlude v. Commissioner*, 372 U.S. 128 (1963); *American Automobile Ass'n v. United States*, 367 U.S. 687 (1961); *Automobile Club v. Commissioner*, 353 U.S. 180 (1957).

[6] The respective payments at issue were unconditionally received and were not subject to either an interest or refund obligation. *See, e.g., Schlude v. Commissioner, supra.* at 135-136 ("[t]he contracts permitted the studio to . . . retain whatever payments were made without restriction as to use and without obligation of refund").

[7] Omitted citation to *Schlude v. Commissioner, supra.* at 129; *American Automobile Ass'n v. United States, supra.* at 688; *Automobile Club v. Commissioner, supra.* at 188-189.

[8] Unless otherwise noted, all section references are to the Internal Revenue Code as amended and in effect during the years in issue.

that they are somehow equivalent to advance payments of income. Such a contention is not supported by the facts or the principles of governing law and the Commissioner's position is incorrect for several reasons.

1. Respondent at the time of receipt possesses no present or fixed right to unfettered control and dominion over a customer deposit

IPL at the time of receipt possesses only a contingent future right to appropriate a customer deposit.[9] The Tax Court correctly recognized that IPL's right to exert dominion and control over a customer deposit is subject to a condition precedent; "[O]nly when a customer failed to pay his bills did the petitioner have a right to decide how the deposits were to be used; only then could the petitioner decide that the deposits were to be used to pay for electricity or services." (Pet. App. 35).[10]

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[9] The Eleventh Circuit in *City Gas Co. v. Commissioner*, 689 F.2d 943 (11th Cir. 1982) ("City Gas II") took the position that the taxpayers in that case possessed a "present right to income" on the basis of a customer's revolving obligation to pay for gas supplied. *Id.* at 946, 950 n.10. However, an accrued right to income for gas supplied is not equivalent to a right to offset a deposit against such accrued income in the absence of the satisfaction of the condition precedent; i.e., either by a failure to pay a bill when due or an election to have the deposit applied to a final bill at voluntary termination.

[10] The condition precedent is also met where the customer, before an automatic refund is made, voluntary terminates services and desires to have the deposit applied against the final bill. In either case, the timing and manner of disposition of the deposit is controlled solely by the customer. Further, at the time the deposit is applied, the amounts offset by the deposit have already been included in income and thus the deposit does not affect income recognition but merely serves its purpose as a stand-by collection device.

Accordingly, IPL's right to apply a customer deposit does not ripen until the occurrence of the future contingency.[11] There is, therefore, no requisite "accession to wealth" at the time of receipt to warrant inclusion of the deposit in income. In contrast, there exists a fixed and "present right" in the case of an advance payment of income. *See, e.g., Brown v. Helvering*, 291 U.S. 193, 199 (1934) ("[w]hen received, the general agent's right to it was absolute. It was under no restriction, contractual or otherwise, as to its disposition, use or enjoyment."). There is, therefore, no basis to conclude that IPL's contingent future right in this case is equivalent to the present and absolute right that exists at the time of receipt in the case of an advance payment of income.

2. The customer deposits in this case are subject to an unconditional refund obligation at the time of receipt

Directly related to the lack of a present and fixed right to income at the time of receipt is the existence of IPL's unconditional legal obligation to return a customer's deposit. IPL's recognition of its fixed obligation to repay a customer deposit precludes any "accession to wealth" at the time of receipt. *See, James v. United States*, 366 U.S. 213, 219 (1961). As stated by the Fifth Circuit, "[b]ecause of the acknowledged liability to

[11] The necessity of the occurrence of a future contingency in the context of a security deposit was expressly acknowledged by the Fifth Circuit in *Astor Holding Co. v. Commissioner*, 135 F.2d 47 (5th Cir. 1943):

> If an amount is deposited with a lessor merely as security for the performance of covenants with no present right or claim of full ownership in the lessor, it is not treated as taxable income unless and until something happens to make the deposit, or a portion of it, the property of the lessor. *Id.* at 48.

account for it, there is no gain; just as in borrowing there is none." *Clinton Hotel Realty Corp. v. Commissioner*, 128 F.2d 968, at 969 (5th Cir. 1942). And by the Tax Court, "[t]he acknowledged liability of the lessor to account for the deposited sum of the lessee's performance of the lease covenants prevents the sum from being taxable in the year of receipt." *J. & E. Enterprises, Inc. v. Commissioner*, 26 T.C.M. (CCH) 944, at 946 (1967). In that regard, it is well settled that there is no taxable gain where there exists a legal obligation to return a security deposit. *See, e.g., Mantell v. Commissioner*, 17 T.C. 1143, 1145, 1148 (1952); *Clinton Hotel Realty Corp. v. Commissioner*, 128 F.2d 968, 969 (5th Cir. 1942); *Warren Service Corp. v. Commissioner*, 110 F.2d 723 (2d Cir. 1940); *Estate of Barker v. Commissioner*, 13 B.T.A. 562, 567 (1928). *See also, Illinois Power Co. v. Commissioner*, 792 F.2d 683, 689 (7th Cir. 1986) ("[t]axpayer is allowed to exclude from his income money received under an unequivocal contractual, statutory, or regulatory duty to repay it, so that he is really just the custodian of the money."); *Consolidated Hammer Dry Plate & Film Co. v. Commissioner*, 317 F.2d 829 (7th Cir. 1963); *Mutual Telephone Co. v. United States*, 204 F.2d 160 (9th Cir. 1953); *Bates Motor Transport Lines, Inc. v. Commissioner*, 200 F.2d 20 (7th Cir. 1952); *Boston Consolidated Gas Co. v. Commissioner*, 128 F.2d 473 (1st Cir. 1942). However, the Commissioner implicitly suggests (Pet. Br. 12, 19) that there is no substantive difference between the refund obligation in this case and those that are present in the case of an advance payment of income. Such a contention ignores the fact that the refund obligation in this case is not contingent, but is created at the time of IPL's receipt of the deposit and continues until the earlier of the occurrence of future contingent events or a refund to the customer. In other words, the obligation

to refund the deposit is not limited by any condition precedent.

In contrast, a refund obligation in the case of an advance payment of income is not an unconditional legal obligation, but is typically contingent upon the occurrence of either a remote future event or an event the occurrence of which is in the exclusive control of the deposit recipient. *See, e.g., Hagen Advertising Displays, Inc. v. Commissioner*, 407 F.2d 1105, 1107 (6th Cir. 1969); *Van Wagoner v. United States*, 368 F.2d 95, 97-98 (5th Cir. 1966); *Hirsch Improvement Co. v. Commissioner*, 143 F.2d 912, 915 (2d Cir.), *cert. denied*, 323 U.S. 750 (1944); *BJR Corp. v. Commissioner*, 67 T.C. 111, 121-123 (1976); *J. & E. Enterprises, Inc. v. Commissioner*, 26 T.C.M. (CCH) 944, 946 (1967). Accordingly, the contingent nature of the refund obligation does not affect the character of the payment as income when received. Thus, it is apparent that a contingent refund obligation in the case of an advance payment of income is not equivalent to the unconditional refund obligation in this case.

3. The burden of respondent's interest obligation effectively restricts the economic use and benefit of a customer deposit

The Commissioner asserts (Pet. Br. 28) that "[T]he presence or absence of such an [interest] obligation, however, provides no basis for distinguishing an advance payment of income and a nontaxable security deposit." To the contrary, the recipient of an advance payment typically has no obligation to pay interest and can therefore "use the advance payment as its own

money." *Astor Holding Co. v. Commissioner*, 135 F.2d 47, 48 (5th Cir. 1943).[12] In contrast to the unrestricted use that exists in the case of an advance payment of income, the presence of an interest obligation such as in this case effectively restricts any economic use and benefit of holding a customer deposit and thus clearly constitutes a basis for distinguishing a taxable advance payment of income from a nontaxable security deposit.[13] Accordingly, the presence of the interest obligation demonstrates that IPL's use of the customer deposits in this case is not equivalent in any respect to the unrestricted use found in the case of a typical advance payment of income.[14]

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[12] As recognized by the Tax Court, an amount is considered an advance payment of income "[w]here the taxpayer has virtually unrestricted control over the amount deposited and does not pay interest on such amount." (Pet. App. 34a).

[13] Contrary to the Commissioner's view (Pet. Br. 29), the courts have recognized that the existence of an interest obligation is material in the context of a security deposit. *See, e.g., Clinton Hotel Realty Corp. v. Commissioner*, 128 F.2d 968, 970 (5th Cir. 1942) ("[t]he lessor's accountability for interest as well as for the principal emphasizes that character [of the deposit as security]"); *Van Wagoner v. United States*, 368 F.2d 95, 98 (5th Cir. 1966) ("[W]e pointed out [in *Astor*] *significantly* that no interest was required to be paid by lessor to lessee which was different from *Clinton* where lessor was obligated to pay annual interest on the deposit.") (emphasis added).

[14] Similarly, the existence of the statutory, contractual and regulatory obligations such as the interest and refund obligations, and the fact that unclaimed deposits escheat to the state, clearly indicate that IPL's control over a customer deposit is also effectively restricted.

C. Both the "functional similarity" and "economic reality" of the customer deposits in this case are analogous to a loan

The Commissioner's erroneous assumptions concerning "functional similarity" (Pet. Br. 17) and "economic reality" (Pet. Br. 21) do not support the contention that the customer deposits in this case are equivalent to advance payments of income.

The Commissioner interprets (Pet. Br. 17) the Seventh Circuit's discussion concerning the "functional similarity between an advance payment of rent and a deposit to secure the payment of rent" (Pet. App. 10a) to mean that the Seventh Circuit recognizes the existence of such a functional similarity. The error of that interpretation is made manifest by a reading of the Seventh Circuit's opinion in relevant part:

> The functional similarity between an advance payment of rent and a deposit to secure the payment of rent suggests that they should be taxed similarly. The *crux of this position* is that the importance of the unconditional obligation to return the deposit amount should not control for tax purposes. . . . In its simplest terms, *the IRS's argument* is that deposits to secure rent must be taxed the same as advance payments. . . . *In the IRS's view, . . . there is no functional difference between the two arrangements.* (emphasis added) (Pet. App. 10a).

It appears clear from the opinion that the Seventh Circuit was simply considering the IRS's argument as to the existence of a "functional similarity," and was not itself agreeing with or adopting that position as suggested by the Commissioner.

The Seventh Circuit did, however, recognize the substantive similarity between a deposit that secures property (nonincome-producing) and a deposit that secures income:

> We note that by overlooking the lessor's legal obligations and focusing on "the economic substance of the transaction," Appellant's Br. at 19, the IRS fails in our view to persuasively explain why deposits to secure income should be treated differently from deposits to secure property that are given in conjunction with a contractural arrangement that generates an income stream (which the IRS concedes should not be included in a taxpayer's gross income upon receipt). (Pet. App. 11a n. 9).
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> Thus, once one focuses on "economic substance," the distinction between a deposit to secure income and a deposit to secure property is not so clear and it is less apparent why a deposit to secure income should be taxed as an advance payment rather than as a deposit to secure property. (Pet. App. 12a n. 9).

As in the case of a deposit to secure property,[15] the Seventh Circuit found that IPL "[w]as legally required

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[15] The Seventh Circuit explained that the rationale for not taxing the receipt of a deposit to secure property (or nonincome covenants) is attributable to the offsetting obligation to refund the deposit if the depositor satisfies the contract conditions (or covenants), which is a situation that is analogous to a loan:

> A deposit to secure tangible property, however, is not considered income because it is offset by an obligation to refund the deposit if the property being used by the depositor is returned to the deposit recipient undamaged. Frequently, the deposit recipient has unrestricted use of the deposit

to "refund" the deposit if a customer established creditworthiness . . ." (Pet. App. 13a), but unlike the holder of a deposit to secure property, IPL was, in addition to its refund obligation, "[a]lso required to pay interest in the interim." *Id.* Accordingly, because of the presence of the interest obligation, IPL's deposit situation is more analogous to a "typical cash loan" than is a typical deposit that secures property, which the Commissioner agrees is a nontaxable security deposit.[16]

The Commissioner quotes a passage from an article by Burke & Friel[17] as support for the proposition that the "economic reality" of the customer deposits in this case is equivalent to that of an advance payment of income. The comment concludes that "The deposit, in all these instances, provides a clear economic benefit in the sense that, to the extent of the deposit, 'future' income has been assured." (internal quotation and citation omitted) (Pet. Br. 22). The comment, in the context of the

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during this time period. Despite this discretion, the deposit recipient is not required to include the deposit in gross income because he or she is not considered to have "gained" for tax purposes. (citations omitted). In this respect, the deposit recipient's situation is analogous to the typical cash loan. The borrower does not include the loan proceeds in gross income because he or she also incurs an obligation to repay the money. *Commissioner v. Tufts*, 461 U.S. 300, 319 (1983). (Pet. App. 7a).

[16] Under Texas law, the legal relationship between a customer and an electric public utility which required a deposit under a contract providing for interest on deposit and return thereof upon discontinuance of service is that of debtor and creditor. *Central Power & Light Co. v. State*, 410 S.W.2d 18 (Tex. Civ. App. 1966), *cert. denied*, 389 U.S. 933 (1967).

[17] Burke & Friel, *Tax-Free Security: Reflections on Indianapolis Power & Light*, 12 Rev. Tax'n Individuals, 157, 173-174 (1988).

facts of this case, fails to acknowledge that the purpose of the customer deposits is to assure the collection of amounts that have been recognized as income by an accrual basis taxpayer before the deposits are actually offset against a bill; i.e., the revenue is recognized independently of whether there is a deposit to secure its payment or not.[18] Because IPL will have already recognized income before the deposit is applied to a customer's bill, the deposit actually secures the collection of an account receivable, a property right. Further, the comment does not consider the likelihood that an interest obligation such as in this case, together with corresponding administrative and regulatory compliance costs, will offset any potential economic benefit of holding a deposit.[19] The comment also ignores the offsetting legal obligation to repay a deposit which, together with the interest obligation, precludes any "accession to wealth" and thus demonstrates that the "economic reality" of the customer deposits in this case is analogous to a loan.

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[18] In that regard, a customer deposit is not unlike pledged collateral on a loan or a cash bond. Moreover, the Commissioner's implicit suggestion that only those deposits which secure nonincome-producing covenants can be considered "akin to a loan" (Pet. Br. 23) is not universally accepted. *See, e.g., Clinton Hotel Realty Corp. v. Commissioner*, 128 F.2d 968, 970 (5th Cir. 1942) ("[W]e are of the opinion that no present gain was realized by this borrowing . . . ."). *See also*, J. Snead, *The Configurations of Gross Income*, 53 (1967) ("The lessor is treated as the borrower of the deposit, not as the recipient of advance rentals").

[19] There is no economic benefit associated with unclaimed customer deposits because those deposits, plus accumulated and unpaid interest, escheat to the state.

Moreover, the purpose and substance of the customer deposits in this case are correctly recognized by the Seventh Circuit:

> Although the recipient is assured that a customer's outstanding bill will be paid, this benefit alone does not constitute "the use" of the proceeds in a manner sufficient to justify immediate taxation of the deposit. The deposit merely assures that IPL will be paid and minimizes collection costs IPL would otherwise incur if the depositor defaults, functions typically associated with security deposits (Pet. App. 14a).

D. The "primary purpose" test formulated by the Eleventh Circuit in *City Gas* allows for disparate treatment and discriminatory application

The "primary purpose" test as formulated by both the Commissioner and Eleventh Circuit will, in cases purportedly involving "mixed" or "dual-purpose" deposits, allow taxpayers to structure their deposit transactions so that they will qualify as nontaxable security deposits. This result could be obtained by simply ensuring that the number of nonincome-producing covenants exceed the number of income related covenants. Under the apparent numerical emphasis of the test (see p. 8, n. 2, *supra.*), it appears that a deposit will be deemed a nontaxable security deposit in cases where the number of nonincome items exceed the number of income items regardless of any other fact or circumstance, including the fact that it is expressly agreed that the deposit is to be applied, for example, as a rent payment in a subsequent period.

The probability of such a result is expressly acknowledged by the Commissioner:

> The correct treatment of such a "dual purpose" security deposit has been explored in the rental cases, and the Revenue Ruling [72-519] and the Eleventh Circuit in *City Gas* have adopted the rule set forth in those cases — namely, the court will look to the primary purpose of the payment, and a payment that is primarily intended to secure the performance of nonincome-producing covenants will not be treated as an advance payment solely because it might be applied as a rent payment (or a payment for goods and services) if there is no prior occasion for applying the deposits. (citations omitted) (Pet. Br. 23 n.10).

In addition to the potential disparate treatment, the "primary purpose" test will operate in a discriminatory fashion against regulated public utilities such as respondent. This is because there are, as a general rule, relatively few nonincome-producing interests (e.g., meters) that could be the subject of a covenant in the context of transactions with regulated public utilities. Accordingly, it will be difficult, if not impossible, for public utilities to tip the scale in favor of a determination that the deposit constitutes nontaxable security under the "primary purpose" test.[20] Moreover, the discriminatory effect of the Eleventh Circuit's "per se" rule as applied to public

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[20] In fact, in cases such as this, the Commissioner will seek to apply this "per se" rule to deposits which only secure the performance of payment obligations:

> In this case, there is no question of such a dual purpose deposit; it is clear that the only purpose for the deposits required by respondent was to secure the payment of future income (Pet. Br. 23 n.10).

utilities has already been recognized by the commentators.

> Although the Eleventh Circuit primary-purpose test will not shield a utility like Indianapolis Power and Light from tax on deposits securing only income items, such utilities may find some limited relief in Reg. § 1.451-5. *See City Gas*, 47 T.C.M. at 977-978.[21]

In contrast to the discriminatory, outcome-determinative approach adopted by the Commissioner and Eleventh Circuit, the Tax Court and Seventh Circuit have properly applied an unbiased facts and circumstances test to evaluate the attendant rights and obligations, and correctly determined thereunder that the customer deposits in this case constitute nontaxable security deposits.

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[21] Burke & Friel, *Tax-Free Security: Reflections on Indianapolis Power & Light*, 12 Rev. Tax'n Individuals 157, 175 n.69.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted,

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AMICUS CURIAE

BRIEF

No. 88-1319

Supreme Court, U.S.
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CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1989

COMMISSIONER OF INTERNAL REVENUE, *Petitioner*,

v.

INDIANAPOLIS POWER & LIGHT COMPANY, *Respondent*.

On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

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BRIEF AMICUS CURIAE IN SUPPORT OF RESPONDENT FILED ON BEHALF OF

American Information Technologies Corporation, Bell Atlantic Corporation, BellSouth Corporation, NYNEX Corporation, Pacific Telesis Group, Southwestern Bell Corporation, US West, Inc., American Telephone and Telegraph Company, The Southern New England Telephone Company

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1989

No. 88-1319

Commissioner of Internal Revenue,
Petitioner,

v.

Indianapolis Power & Light Company,
Respondent.

BRIEF AMICUS CURIAE
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Southwestern Bell Corporation
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American Telephone and Telegraph Company
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On Writ of Certiorari to
the United States Court of Appeals
for the Seventh Circuit

STATEMENT OF INTEREST OF AMICUS CURIAE

Amicus curiae American Telephone and Telegraph Company and certain of its former operating subsidiaries currently have pending before the United States Tax Court a case involving the issue presented in the instant case. *American Telephone and Telegraph Co. and Consolidated Subsidiaries* v. *Commissioner*, Tax Court Docket No. 2737-89. Approximately $100 million in tax deficiencies is involved. *Amicus curiae* American Information Technologies Corporation, Bell Atlantic Corporation, BellSouth Corporation, NYNEX Corporation, Pacific Telesis Group, Southwestern Bell Corporation, and US West, Inc. are the current parent corporations of the former operating subsidiaries of American Telephone and Telegraph Company involved in the pending Tax Court case.

Amicus curiae The Southern New England Telephone Company also has similar cases currently pending in the United States Tax Court, Docket Nos. 552-87 and 22171-88.

The written consents of the parties in the instant case to the filing of this brief *amicus curiae* have been filed with the Clerk.

SUMMARY OF ARGUMENT

A. Under petitioner's test, a deposit is taxable on receipt if its purpose is "to secure the payment of future income," but not if its purpose is "to secure the performance of a nonincome-producing covenant." Respondent, an accrual method utility, was required to, and did in fact, accrue income when its right to receive such income became fixed, *i.e.*, as service was

rendered, meters were read, and bills were sent. Subsequent payment of those bills by customers did not give rise to additional income in respondent's hands. Since, as both parties agree, the deposits received by respondent were intended to secure the payment of future bills, what they secured was customer performance of a *nonincome-producing* covenant. Under petitioner's own test, therefore, the deposits were not income on receipt.

B. Petitioner contends that the instant deposits are "basically identical" to taxable "advance payments." Prior decisions of this Court have made it clear, however, that from the payor's standpoint, a remittance does not constitute a "payment" for tax purposes unless it relates to an existing and fixed liability. Here, when a deposit was received, there was no definite liability to which it related and no assurance that the deposit would ever be applied in satisfaction of a liability. Consequently, the deposit cannot be characterized as a "payment" on receipt, and therefore cannot be taxed as an "advance payment" for service. Rather, in accordance with prior precedent, unless and until a deposit is applied in satisfaction of an existing liability, the deposit is properly characterized as "in the nature of a cash bond"—a security remittance that itself is not taxable.

C. Respondent's income from the provision of utility services has been clearly reflected for at least 50 years. If, as petitioner contends, the deposits constitute taxable advance payments on receipt, a double counting of income for the same service will result. That is because under normal accrual rules, respondent would have accrued each month's income as service was rendered. If the deposit is also treated

as income on receipt, an inevitable double counting will occur whenever a customer's default results in bills remaining unpaid at the close of a taxable year, with the deposit then becoming applicable to such bills. An offsetting deduction to reflect application of the deposit against the unpaid bills would not be allowable until the application occurred in the following year, thus producing an impermissible distortion of income and deductions for the two-year period.

D. The facts and circumstances test adopted by the Tax Court, and adhered to by the court below, is the only appropriate test to be applied in determining whether customer security deposits produce the requisite "accession to wealth" that would give rise to taxable income to the utility. Unless all circumstances surrounding the receipt, retention and refunding of the deposits are taken into account, a court cannot properly ascertain whether the funds should be treated as income on receipt, or whether they are more akin to a loan or a cash bond. The deposits here involved were collected from only a small group of customers, were not intended as prepayments for service, were held for only a limited period of time before being applied to a bill or otherwise refunded with interest, and were treated while held as liabilities of the utility pursuant to regulatory requirements. They thus did not give rise to an "accession to wealth" to the utility, and therefore cannot be held to constitute taxable income on receipt.

ARGUMENT

REFUNDABLE SECURITY DEPOSITS COLLECTED BY A REGULATED PUBLIC UTILITY FROM NONCREDITWORTHY CUSTOMERS DO NOT CONSTITUTE GROSS INCOME ON RECEIPT.

A. Under Petitioner's Own Test, the Deposits Were Not Income.

This is not a technical tax case. It raises, in a unique setting, the most fundamental of all questions presented under the tax laws—the proper scope of the term "gross income" as used in section 61(a) of the Internal Revenue Code. The specific issue is the proper characterization of security deposits collected by a regulated public utility from its noncreditworthy customers and refunded promptly upon the establishment of creditworthiness. Are such funds taxable or nontaxable to the utility?

Petitioner resolves the foregoing question in favor of taxability by relying on a test that distinguishes between "a deposit to secure the payment of future income and a deposit to secure the performance of nonincome-producing covenants." (Pet. Br. 22.) Petitioner contends that the deposits here in question were intended to "secure the payment of future income" or to "secure the future payment of funds that will become income." (Pet. Br. 17, 22.) Accordingly, under petitioner's view, such deposits are "not meaningfully different" from advance payments of income and therefore are taxable upon receipt. (Pet. Br. 19.)

Petitioner's test is derived from, though not identical to, the test applied by the Eleventh Circuit in *City Gas Co. of Florida* v. *Commissioner*, 689 F.2d 943 (11th Cir. 1982). In *City Gas*, a deposit was col-

lected from each new customer, was held throughout the service period, and generally was applied against the customer's final bill. The Eleventh Circuit declared that the proper test to be utilized to determine the taxability of the deposits there involved was whether the "primary purpose" for the deposits was "a prepayment of income items or . . . to secure the performance of nonincome-producing covenants." 689 F.2d at 948.

Petitioner here modifies the Eleventh Circuit test by substituting his own version of the first prong and restating the test as follows: does the deposit "secure the payment of future income" or does it "secure the performance of nonincome-producing covenants"? (Pet. Br. 22.) This modification is undoubtedly compelled because, unlike the situation in *City Gas*, the deposits held by respondent were refundable promptly upon the customer's establishment of creditworthiness, and thus clearly were *not intended* as "a prepayment of income items."[1]

While petitioner's modified test has a certain superficial appeal, it rests entirely on a totally fallacious premise—that the payment of utility bills will give

[1] Petitioner cannot rely upon this Court's prior decisions in *Schlude* v. *Commissioner*, 372 U.S. 128 (1963); *American Automobile Ass'n* v. *United States*, 367 U.S. 687 (1961); and *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180 (1957). Those cases involved the proper time for reporting what were admittedly advance payments of income. This Court did not have to consider the significance of subsequent billings because none were contemplated by the parties. Here, the sole issue is whether, notwithstanding regular monthly billings by respondent as services were rendered, the deposits in question nevertheless can properly be characterized as taxable advance payments on receipt.

rise to future income. That is simply not correct, and is in fact a misstatement of fundamental tax accounting principles.

As a regulated public utility using the accrual method of accounting for tax purposes, respondent was required to accrue income each month as its right to receive such income was fixed, *i.e.*, as service was rendered and meters were read, with bills sent the following day. The subsequent payment of those bills by respondent's customers did not, and could not, give rise to income—that occurred as the service was rendered. *Spring City Foundry Co.* v. *Commissioner*, 292 U.S. 182, 184 (1934); Treas. Reg. § 1.451-1(a) (the "all events" test).

For an accrual method taxpayer such as respondent, the receipt of payment on an outstanding bill is simply a tax-neutral event. Failure to receive payment on a bill would not cause income to go unreported; it would merely provide the occasion for claiming a bad debt deduction to reflect the worthlessness of an account receivable. While the application of a security deposit against the unpaid bill would mitigate the loss, it would not—and could not—give rise to income.

Here, both parties agree that the deposits in question were intended to secure the customer's obligation to pay future bills. (Pet. Br. 19; Resp. Br. 31.) That being the case, it cannot be said that the deposits secured future income. There is simply no "income content" in a deposit that secures payment of future bills owed to an accrual method taxpayer such as respondent. Such a deposit must be characterized,

therefore, as a deposit to secure the performance of a *nonincome-producing* covenant.[2]

In addition, from the utility's perspective, the deposit could also be viewed as securing accounts receivable, *i.e.*, unpaid bills. Such receivables are, of course, "property" in respondent's hands. Consequently, under such a view, the deposit would be securing against property damage, *i.e.*, loss attributable to nonpayment, and therefore would again secure a "nonincome-producing" covenant.

By petitioner's own admission, a deposit "to secure against property damage or the performance of other nonincome-producing covenants is akin to a loan, which does not generate income." (Pet. Br. 23.)

It follows from all the foregoing that under petitioner's own test, respondent must prevail.

B. A Refundable Customer Security Deposit is Not an Advance Payment, But Rather is in the Nature of a Cash Bond.

Petitioner supports his position that security deposits are "basically identical" to advance payments by contending that "[f]rom the perspective of both the payor and the recipient," advance payments and security deposits "serve the same function" and "operate in essentially the same manner." (Pet. Br. 17-18). Petitioner's position cannot be reconciled with this Court's prior pronouncements as to when, from the payor's standpoint, a remittance will be deemed

[2] It is no answer to suggest that because the deposit secures future payments, it is itself the equivalent of a "payment," and therefore is taxable as an "advance payment." Such a play on words cannot *ipso facto* give income content to the deposit.

to constitute a "payment" for Federal income tax purposes.

In *Rosenman* v. *United States*, 323 U.S. 658 (1945), this Court considered whether a taxpayer's remittance of funds into an IRS suspense account prior to a formal assessment of tax liability was a "payment" of tax that started the running of the statute of limitations for claiming refunds. This Court held that the remittance was not a "payment" of tax and "carrie[d] no more significance than would the giving of a surety bond. Money in these [suspense] accounts is held not as taxes duly collected are held but as a *deposit made in the nature of a cash bond* for the payment of taxes thereafter found to be due." *Id.* at 662 (emphasis added). See also, *United States* v. *Consolidated Edison Co.*, 366 U.S. 380 (1961), involving the deductibility of a remittance covering a contested property tax liability. This Court held that, until the contest was resolved, the remittance was not a "payment," but "a mere deposit 'in the nature of a cash bond.'" *Id.* at 391.

Rosenman establishes that where a remittance is made prior to the time a fixed liability arises, the remittance cannot be considered a "payment" in satisfaction of the liability. Rather, in such a case, the remittance must be characterized as a deposit in the nature of a cash bond that has no more tax significance to either the payor or the payee than would the posting of any other form of collateral. The remittance is treated as a "payment," if at all, only when the liability actually becomes fixed.

In the case of a refundable security deposit, the customer has no fixed liability to satisfy at the time the deposit is made. Once the customer begins to

receive service, he is billed monthly and becomes obligated to make regular payments to the utility. In accordance with regulatory requirements, it is only after a customer is in default for a specified period with respect to a particular bill that the utility is authorized to apply the deposit in satisfaction of the unpaid liability.

Petitioner explicitly acknowledges that the deposit is collected "to apply to the bill for the period in which the customer defaults." (Pet. Br. 21.) What petitioner thus implicitly acknowledges is that until so applied, the deposit is nothing more than a form of security for future payment, *i.e.*, a cash bond.

Since the holder of a cash bond does not know at the time it receives the bond whether or when a default will occur, it is not required to recognize income on receipt. See *Estate of Barker* v. *Commissioner*, 13 B.T.A. 562, 568 (1928) (lease deposit not taxable on receipt, but instead viewed as "security in the nature of a cash bond"). It would thus be inconsistent with prior precedent to characterize the deposits here involved as taxable advance payments at the time of receipt.

C. Recharacterization of the Customer Security Deposits As Advance Payments Will Result in the Double Counting of Income.

As noted above, respondent properly accrued its income as services were rendered to customers during the years here in question. Consequently, if petitioner is also allowed to tax the deposits collected by respondent in those years, a "double counting" of income will result.

The consequences of petitioner's theory are illustrated by a simple example. Assume that respondent

begins supplying electric power to a customer on September 1 and because the customer is unable to establish his creditworthiness, respondent collects a $50 deposit. Assume further that on September 30, in the normal course of its operations, respondent accrues $25 of income for one month's service and sends a bill in that amount to the customer. Payment is received by the end of the next month. Similar accruals, billings, and payments occur with respect to service rendered in October, November and December, although payment of the December bill will not be received until some time in January of the next taxable year.

At the close of the first year, respondent would report and pay tax on the $100 of income accrued for services rendered during the year ($25 in each of four months). Under petitioner's theory, however, because respondent received a $50 deposit in September, respondent would be required to report $150 of income for the year (the $50 deposit plus $100 for services rendered). Yet, if the $50 deposit is to be characterized as a taxable "advance payment" for services to be rendered, as petitioner advocates, surely respondent cannot be required to report *both* that "payment" and the normal accrual of income attributable to the same services.

Petitioner does not suggest that respondent should cease accruing income under normal accrual principles to reflect treatment of the deposit as an advance payment. Rather, he is presumably willing to ameliorate the double counting problem by allowing an offset to income at the time the deposit is applied to an unpaid bill or otherwise refunded to the customer. However, if the customer defaulted on his November

and December bills, the deposit would not be applied against such bills until the following year, when the utility would first become authorized to do so. At that time, the income for the first year's service would already have been accrued and reported in the normal course. As a result, a double counting of income in the first year relating to the same November-December service (the $50 deposit plus $50 in normal monthly accruals, or $100 of income attributable to $50 worth of service) would inevitably have occurred under petitioner's theory.

While the double counting would be offset through allowance of some sort of a deduction when the deposit is applied to the unpaid bills in the following year, this would completely distort the true picture of respondent's income in the first year and its deductions in the second year.

Here, respondent's income from the provision of utility services has been clearly reflected for at least 50 years, by virtue of its regular monthly accruals of income, with deductions allowed for worthless accounts. Respondent's income would not be clearly reflected if, in addition to its regular monthly accruals, deposits must also be treated as income on receipt. In such a case, deductions then would have to be allowed not only when accounts become worthless, but also each time a deposit is offset against an unpaid bill or otherwise refunded. This Court should not embrace a theory of taxation that produces such a double counting and resulting distortion of income and deductions.

D. The Facts And Circumstances Test is the Correct Test to be Applied For Purposes of Characterizing Customer Security Deposits.

As developed more fully in respondent's brief (Resp. Br. 9-13), refundable customer security deposits can properly be taxed on receipt only if, under *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426 (1955), and *James* v. *United States*, 366 U.S. 213 (1961), they are received without the consensual recognition of an obligation to repay, and therefore give rise to an "accession to wealth" to the utility. The only appropriate way to determine whether such an accession to wealth has occurred is to examine all the facts and circumstances surrounding respondent's receipt, retention and refunding of the deposits. An examination of the parties' rights and obligations under their agreement is the approach consistently adopted by the Tax Court when considering the taxability of customer security deposits, is the approach adhered to by the court below, and is the approach that should be adopted by this Court today.

In lieu of the Tax Court's "facts and circumstances" test, petitioner invites this Court to adopt a rigid rule that all deposits received by public utilities to secure the payment of future bills should be treated as advance payments and taxed upon receipt. Whatever administrative advantages petitioner would derive from adoption of such a rule, petitioner's approach simply ignores the myriad of factors relevant to determining the true tax character of customer deposits.

Notwithstanding the fact that not all deposits fit neatly into a single mold, petitioner decries the prospect of lower courts having to resolve future disputes

on the basis of "factbound" determinations of taxability. (Pet. Br. 34.) Interestingly, however, the Tax Court has experienced no difficulty thus far in applying the facts and circumstances test in deposit cases, reaching disparate results where the facts warrant it. Compare, for example, *American Telephone and Telegraph Co.* v. *Commissioner*, 55 T.C.M. (CCH) 16 (1988), with *Oak Industries, Inc.* v. *Commissioner*, 52 T.C.M. (CCH) 1556 (1987).

Petitioner endeavors to rob the facts and circumstances test of its vitality by isolating and denigrating each factor as not individually controlling. Only if all facts and circumstances are considered in combination, however, can there be assurance that the characterization of all types of deposits will be harmonized with the definition of the term "gross income" so carefully crafted by this Court over many years.

Here the relevant facts and circumstances are that the deposits were obtained from only a small percentage of customers; were not intended as prepayments for service; were required to be, and were in fact, treated as liabilities while held by the utility; were retained pursuant to regulatory requirements only for the limited number of months deemed necessary to establish the customer's creditworthiness, unless applied sooner in the event of default; and were otherwise promptly refunded with interest, with any unclaimed deposits ultimately escheating to the state. Accordingly, the deposits cannot constitute gross income because respondent enjoyed no "accession to wealth" on their receipt.

CONCLUSION

The decision of the Court of Appeals for the Seventh Circuit should be affirmed.

Respectfully submitted,

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AMICUS CURIAE

BRIEF

No. 88-1319

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1989

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Petitioner,

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INDIANAPOLIS POWER & LIGHT COMPANY,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

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BRIEF FOR OAK INDUSTRIES, INC. AND SUBSIDIARIES AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENT

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QUESTION PRESENTED FOR REVIEW

Whether customer deposits required by a public utility to insure the payment of future bills are income to the utility upon receipt.

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BRIEF FOR OAK INDUSTRIES, INC. AND SUBSIDIARIES AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENT

INTEREST OF THE *AMICUS CURIAE*

Oak Industries, Inc. and Subsidiaries ("Oak"), with the consent of the parties, submits this brief as *amicus curiae* in support of respondent's position. Oak, a consolidated group of corporations headquarted in Rancho Bernardo, California, is the petitioner in *Oak Industries, Inc.* v. *Commissioner*, No. 37866-84 (T.C. filed Nov. 5, 1984). In a memorandum opinion issued on January 29, 1987, the Tax Court held that certain security deposits received from customers by National Subscription Television, a partnership in which Oak participated, were income upon receipt. *See Oak Industries, Inc.* v. *Commissioner* 52 T.C.M. (CCH) 1556 (1987). The decision of

the Court in this proceeding could affect Oak's position in the Tax Court litigation.

STATEMENT OF THE CASE

1. Respondent Indianapolis Power & Light Company ("IPL") is a regulated public utility engaged in generating and selling electricity and steam in Indianapolis, Indiana, and neighboring areas. (Pet. App. 2a and 20a). During the years in issue, IPL collected security deposits from approximately 5 percent of its customers who could not meet creditworthiness standards. The receipt issued to such customers stated that the deposits were "to insure prompt payment of electrical service." (Pet. App. at 2a). Commercial customers often made different arrangements in lieu of cash deposits, including submission of letters of credit or the pledge of assets. (Pet. App. 20a). When a customer demonstrated creditworthiness, either by satisfying certain standards or making timely payments of utility bills, the deposit was refunded. (Pet. App. at 2a). At the customer's option, the refund was in the form of cash, check or a credit to the customer's bill.

IPL did not segregate the customer deposits from its other assets. (Pet. App. at 3a). Under the rules of the Public Service Commission of Indiana, IPL was required to pay interest on certain deposits. Before March 10, 1976, IPL was required to pay interest at the rate of three percent on deposits held for more than six months. After March 10, 1976, IPL was required to pay interest at the rate of six percent on deposits held for 12 months or more. IPL treated unrefunded deposits as liabilities and not as income for regulatory accounting and tax purposes. (Pet. App. at 4a, n.3; Stip. Facts ¶ 20; and Tr. 11). Petitioner Commissioner of Internal Revenue (the "Commissioner") questioned the latter treatment, taking the position that such deposits were in reality advance payments and should be included in IPL's income upon receipt. (Pet. App. at 1a).

2. The Tax Court rejected the Commissioner's position and found that the refundable deposits collected by IPL were not includible in its income. (Pet. App. at 19a-39a). The court evaluated all the facts and circumstances to determine "the rights retained by the depositor and the rights acquired by the holder of the deposit." (Pet. App. at 34a). The Tax Court found it significant that the deposits were not intended as advance payments; customers had the right to control the ultimate disposition of the deposits; and IPL treated the deposits as liabilities owing to the customers, could apply deposits to bills only on customer default, and paid interest on the deposits. (Pet. App. at 34a-36a).

The Court of Appeals for the Seventh Circuit affirmed the Tax Court's decision, holding that the deposits served as security and not as prepayments. (Pet. App. at 17a). The court rejected the rule proposed by the Commissioner, which would treat any deposit that primarily secured the payment of future bills for utility services as a taxable advance payment. The court noted that when interest is paid on a customer deposit, the "return factor" from holding the deposit is minimized and the principal benefit of the deposit is its "security factor." That IPL was obligated to pay interest on deposits, that customers controlled the timing of the return of their deposits, and that IPL never intended to have the deposits serve as prepayments caused the court to conclude that the deposits were not income upon receipt.

SUMMARY OF ARGUMENT

The narrow principle of law articulated by the court of appeals below is that, under the proper circumstances, a deposit to secure payment of an income item is not an advance payment for federal income tax purposes. The court of appeals properly declined to disturb the Tax Court's decision that the deposits in question functioned as security for future performance, and thus were not income on receipt. This Court should affirm the holding

of the court of appeals and reject petitioner's assertion, which is based on *City Gas Co. of Florida* v. *Commissioner*, 689 F.2d 943 (11th Cir. 1982), that deposits to secure income covenants are, of necessity, advance payments.

Although the narrow ruling below merits approval, this Court should not endorse the court of appeals' reliance on the payment *vel non* of interest on deposits as the touchstone of analysis in customer deposit cases. From a conceptual standpoint reliance on the interest factor is at best problematic. The tax ownership of an income stream is not generally probative as to tax ownership of the underlying principal sum.

The better approach is to focus on the factual issue considered most significant by the Tax Court in this case, that is, which party to the transaction controls the ultimate disposition of the funds. If, under the terms of the transaction, the taxpayer is obligated to refund the deposit at such time as the depositor has discharged its contractual obligations the taxpayer, the deposit is a security device and not an advance payment. If, on the other hand, the taxpayer is entitled to retain the deposit unless it fails to perform its obligations under the contract, the deposit is an advance payment. This rule of law is supported by the weight of relevant authority, and would bring a measure of predictability to an increasingly chaotic corner of the tax law without restricting petitioner's ability to prevent abuses.

Petitioner's contention that a "deposit" that secures against customer breach of a payment obligation is economically equivalent to a prepayment ignores meaningful distinctions between these two transactions. The taxpayer who receives a bona fide deposit has a liability to account for its return and thus does not thereby increase its net worth. The taxpayer who receives an advance payment or a "deposit" that is automatically applicable to rent or fee obligations, on the other hand, does not have a liability that offsets receipt of that payment. A deposit

carries different common-law consequences than an advance payment, and these distinct consequences are meaningful for tax purposes. Petitioner's economic equivalence analysis is based on the erroneous factual premise that a bona fide deposit is economically equivalent to a prepayment and on the discredited legal premise that a transaction can be recast into whatever economically equivalent form generates the greatest tax revenue. The rule of law advocated herein would not prevent petitioner from treating as income amounts labeled as "deposits" if the parties intended such "deposits" to be applied in payment of rent or fees.

ARGUMENT

I. THE PROPER TREATMENT OF CUSTOMER DEPOSITS REQUIRES APPLICATION OF ESTABLISHED PRINCIPLES OF FEDERAL INCOME TAXATION.

Before considering the specific question presented in this case, it is important to set forth certain principles of federal income tax law that must be applied in reaching the proper conclusion as to whether deposits of the type received by respondent are income upon receipt. Neither petitioner nor the courts below adequately addressed these principles.

A. Taxation Requires an Actual or Assumed Accession to Wealth.

The federal income tax is imposed on *income*, which at a minimum requires the presence of two elements: an accession to the taxpayer's wealth [1] and an event whereby

[1] The only even arguable exceptions to the accession to wealth principle are those necessary to preserve the integrity of the income tax system itself, as where a taxpayer recovers a previously deducted item (including by way of a sale of property on which depreciation deductions have been taken in excess of economic depreciation). Even in these cases, since the premise behind the deduction was that the taxpayer's net worth had declined, taxation

that accession is in some sense realized by the taxpayer. *See Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955). The mere receipt of cash that does not reflect a corresponding increase in the taxpayer's net worth is not a taxable event. Thus, it is elementary that a taxpayer's receipt of loan proceeds is not a taxable event because the resulting increase in the taxpayer's cash assets is offset by the taxpayer's liability to repay the loan.[2] So long as the repayment obligation is one that the parties intend to honor, *i.e.*, is bona fide, loan proceeds are non-taxable.

If a taxpayer receives amounts which he is under a contractual, statutory or common law obligation to return, he may nonetheless be taxable on those amounts under the so-called claim of right doctrine as applied in *James* v. *United States*, 366 U.S. 213 (1961), if he treats them as his own. Such amounts may not appear to represent an accession to the taxpayer's wealth since the taxpayer has a corresponding obligation to return them. But the very basis for taxation in these cases is that the taxpayer has no intention, at least at the time the funds are received, of repaying them. As in the treatment of loans that are not bona fide, if there is no intention to honor an enforceable local law liability, that liability is ignored for federal income tax purposes.[3]

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of the recovery of the amount deducted is based on the corresponding premise that the taxpayer's net worth has increased as a result of the recovery. *See also* Kohl, *The Identification Theory of Basis*, 40 Tax. L. Rev. 623, 632 (1985).

[2] *See Commissioner* v. *Tufts*, 461 U.S. 300, 307, *reh'g denied*, 463 U.S. 1215 (1983); 1 B. Bittker and L. Lokken, *Federal Income Taxation of Income, Estates and Gifts* ¶ 6.2 (2d ed. 1989).

[3] If a liability to repay funds is acknowledged but merely contingent, receipt of those funds may be taxable under the claim of right doctrine or otherwise because the liability is not, and may never become, fixed. A contingent liability, therefore, does not offset the increase in the taxpayer's net worth from receipt of the funds. *Se Nordberg* v. *Commissioner*, 79 T.C. 655 (1982). Similarly, the

B. The Commissioner's Discretion to Recharacterize Bona Fide Arm's-Length Transactions Is Narrowly Circumscribed.

Although the Commissioner has discretion to interpret and apply the tax laws to prevent tax avoidance, when parties dealing at arm's length arrive at an agreement that has substantial non-tax consequences, and intend to enforce their rights and honor their obligations, that discretion is narrowly circumscribed. *See Frank Lyon Co.* v. *United States*, 435 U.S. 561 (1978). This is particularly true where the relationship between the parties is a commercially established, accepted and reasonable practice. If the form selected by the parties reflects the substance of a transaction, the Commissioner cannot recharacterize the transaction to maximize tax liability.[4]

C. Customer Deposits that Primarily Secure Non-Income Covenants Are Not Taxable Upon Receipt.

A customer deposit is not taxable to the recipient (*i.e.*, the taxpayer) upon receipt—even if held by the taxpayer and commingled with other funds—unless it is properly characterized as a current or advance payment for goods, services or the use of property rather than a deposit for federal income tax purposes. *See Clinton Hotel Realty Corp.* v. *Commissioner*, 128 F.2d 968 (5th Cir. 1942); *Warren Service Corp.* v. *Commissioner*, 110 F.2d 723 (2d Cir. 1940); *Estate of Barker* v. *Commissioner*, 13 B.T.A. 562 (1928). Moreover, as virtually every court—including the court of appeals below and

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liability to return prepaid income if goods or services sought in return are not provided does not offset receipt of the income because the existence of the liability is contingent upon the taxpayer not doing what it has contracted to do.

[4] *See Commissioner* v. *Brown*, 380 U.S. 563, 579-80 (1965) (Harlan, J., concurring); Isenbergh, *Musings on Form and Substance in Taxation*: Federal Income Taxation of Income, Estates and Gifts *by Boris I. Bittker*, 49 U. Chi. L. Rev. 859 (1982).

the court of appeals in *City Gas Co. of Florida* v. *Commissioner*, 689 F.2d 943 (11th Cir. 1982), *rev'g* 74 T.C. 386 (1980)—and petitioner agree, when a deposit primarily or exclusively secures the customer's performance of non-income covenants—*i.e*, those other than for future payment of rent, fees for services or purchase price—the deposit is not taxable upon receipt, but only at the time the customer forfeits its rights to the deposit to the taxpayer. *See City Gas Co.*, 689 F.2d at 946; *Indianapolis Power & Light Co.* v. *Commissioner*, 857 F.2d 1162, 1165-66 (7th Cir. 1988); Rev. Rul. 72-519, 1972-2 C.B. 32.

II. THE NARROW HOLDINGS OF THE SEVENTH CIRCUIT AND THE TAX COURT SHOULD BE AFFIRMED.

The Tax Court and the court of appeals below held that customer deposits received by IPL to secure against the nonpayment of customer service fees were not taxable to IPL upon receipt. Because IPL was obligated to return deposits not used to compensate for customer failure to make payments for service and because it could not apply the deposits to service fee obligations in the absence of customer failure to meet those obligations, the narrow holdings of the Tax Court and the court of appeals are correct. The reasoning used by the court of appeals and, to a lesser extent the Tax Court, however, is ill-conceived.

A. To the Extent that the Court of Appeals Relied on Respondent's Payment of Interest, that Reliance Was Misplaced.

Because IPL was obligated to pay interest on deposits, because customers controlled the timing of the return of their deposits,[5] and because IPL never intended to have

[5] To the extent that the court placed emphasis on the fact that IPL's customers could get back their deposits even before utility

the deposits serve as prepayments, the court of appeals held that the deposits were not taxable upon receipt. The court emphasized that IPL derived relatively little economic benefit from the deposits. The court noted that a deposit securing a customer's performance of income covenants potentially served two functions: to permit the taxpayer to enjoy the economic benefit of the deposit and to avoid collection costs in the event of customer default. In the court's view, such a deposit was taxable upon receipt only if the economic benefit derived by the taxpayer predominated over the reduction in collection costs. The court concluded that, because IPL was required to pay interest on deposits, the economic benefit it derived from the deposits was less important than its potential benefits from reduced collection costs. Thus, the court's opinion can be read as placing primary reliance on respondent's obligation[6] to pay interest in determining that such de-

service was terminated, that emphasis is misplaced. That a customer can obtain the return of his deposit only by meeting all of his obligations throughout his relationship with a taxpayer does not make the deposit any less a security device or any more a prepayment. What is important is that the customer, simply by fulfilling all obligations secured by the deposit, be entitled to get the deposit back. If so, there is no accretion to the taxpayer's wealth, even if the deposit cannot be returned until the parties' relationship ends.

To place importance on the customer's inability to get back his deposit before his relationship with the taxpayer ends is particularly inappropriate to the extent that the deposit secures the taxpayer's right to the return of property undamaged. In that case, even if the deposit also secures an income covenant, the business reason for the deposit would remain until the parties' relationship ends and the customer returns the property in good condition. No possible inference of prepayment can be drawn from the customer's inability to recover his deposit until all payments have been made.

[6] The court of appeals relied on respondent's *obligation* to pay interest on deposits and made no attempt to determine the extent

posits were not income upon receipt.[7]

To the extent that the court relied on the taxpayer's payment or non-payment of interest, that reliance is based on the erroneous premise that ownership of property (in this case, the deposit itself) for income tax purposes necessarily follows ownership of the income generated by such property. This premise has no support either in logic or prior authority.

The premise is conceptually untenable because the issue is which party is to be taxed on the receipt of the deposit itself, not on the income therefrom. Common law ownership of property is often separated from common law ownership of income derived from that property. As a general rule, the tax law respects that separation. For example, except to the extent specifically provided by statute, the proceeds of an interest-free loan are not taxable to a borrower, although the borrower has the right to all earnings from those proceeds.[8] Earnings from investment of a deposit are taxed to whomever is entitled to them as a matter of common law. In the instant case, customers who received interest payments from respondent on the deposits were fully taxable on

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to which interest was in fact paid. Respondent was in no case required to pay interest on deposits retained for less than six months and, after March 1976, on deposits (which could be refunded in as little as nine months) retained less than 12 months. On pre-March 1976 deposits held more than six months, interest was payable at the rate of only three percent.

[7] Such a reading may not accurately reflect the basis for the court's decision. The court of appeals stated that it looked at all facts and circumstances, including those relied on by the Tax Court below, in reaching its conclusion. Moreover, the court applied its test to a situation in which the deposits served no property protection purpose.

[8] *Dean* v. *Commissioner*, 35 T.C. 1083, 1090 (1961).

those payments. IPL was fully taxable on earnings generated from its investment of the deposits. The failure to pay interest on an amount that the taxpayer has a clear obligation to repay—as is true of IPL here—does not make the amount itself taxable to the taxpayer.

The tax law has recognized the separation between ownership of income from property and ownership of the property giving rise to that income. Thus, the courts and the Service have long recognized that earnings on amounts escrowed in connection with an installment sale of property may be currently paid to or retained for the benefit of the seller without causing the amounts deposited in escrow to be taxable to the seller. *Stoner* v. *Commissioner*, 79 F.2d 75 (3d Cir.), *cert. denied*, 296 U.S. 650 (1935); *Stiles* v. *Commissioner*, 69 T.C. 558 (1978), *acq.*, 1978-2 C.B. 3; *Murray* v. *Commissioner*, 28 B.T.A. 624 (1933), *acq.*, XII-2 C.B. 10.[9]

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[9] The issue in these situations is whether the taxpayers should be taxable on the escrowed amounts under the economic benefit, or cash equivalent, doctrine. This doctrine is invoked to tax a taxpayer with respect to amounts that have been promised, but not received (and are not receivable at the taxpayer's discretion). A prerequisite for application of the doctrine is that the promise be intended to represent payment of (rather than mere evidence of or security for) the amount owed. *See Schlemmer* v. *United States*, 94 F.2d 77 (2d Cir. 1938); Davies, *Public Stock, Private Stock: A Model for the Corporate Income Tax*, 124 U. Pa. L. Rev. 299, 323 (1975); Metzer, *Constructive Receipt, Economic Benefit and Assignment of Income: A Case Study*, 29 Tax L. Rev. 525, 553-54 (1974). Thus, the doctrine may not be invoked when the promise does not represent an accretion to the taxpayer's wealth, as where the taxpayer's entitlement to the benefit inherent in the promise is contingent upon satisfying, or forfeitable upon not satisfying, specified conditions. The presence or absence of interest is not determinative of whether such a promise is intended as payment, *see Dial* v. *Commissioner*, 24 T.C. 117 (1955), *acq.*, 1955-2 C.B. 5, but it obviously does affect the fair market value of the promise, which is includible in income if the economic benefit doctrine applies.

Similarly, the courts have declined to invoke the claim of right doctrine to tax the possession of property simply because the possessor is entitled to retain all earnings from the property. An amount that is received subject, at the time of receipt, to an acknowledged legal or contractual obligation of repayment does not become taxable under the claim of right doctrine simply because the recipient retains the earnings generated therefrom. Thus, in *Angelus Funeral Home* v. *Commissioner*, 47 T.C. 391 (1967), *acq.*, 1969-1 C.B. 20, *aff'd on other grounds*, 407 F.2d 210 (9th Cir.), *cert. denied*, 396 U.S. 824 (1969), the court rejected the Service's argument that amounts paid to a funeral home were taxable on a claim of right theory, even though the taxpayer had full temporary use of the funds, including the right to invest them, without any obligation to pay over earnings or interest.

Tax "ownership" of income is relevant to tax ownership of the property generating that income only where common law ownership of the property is unclear or has no substance.[10] IPL's liability to account for customer deposits is, however, unquestioned. Even when common law

[10] The instant case should also be contrasted to situations in which ownership of underlying property determines who is taxed on income from that property where the owner of the property seeks artificially to assign income from that property to a tax-favored taxpayer. The assignment of income doctrine is concerned with the proper party to whom income should be taxed, and not the proper time for taxing that income. Furthermore, the assignment of income doctrine does not operate to treat the taxpayer who receives income from property as owning or having received the property itself for federal income tax purposes. *Cf. Commissioner* v. *P.G. Lake, Inc.*, 356 U.S. 260 (1958); *Hort* v. *Commissioner*, 313 U.S. 28 (1941) (income streams assumed to be transferable apart from underlying property). Most importantly, the assignment of income doctrine is concerned solely with taxing income to the first taxpayer who has a vested legal right to the income, and looks to ownership of the property giving rise to that income only to the extent that such ownership is relevant in determining who initially had the vested legal right to the income. *See Commissioner* v. *Sunnen*, 333 U.S. 591, 604-05 (1948).

ownership of property is unclear, ownership of investment earnings is at most evidence of ownership of the underlying property. That factor is never determinative of ownership of the property.[11]

B. To the Extent the Tax Court Below Relied on Factors Other than Respondent's Control Over the Ultimate Disposition of the Deposits, Its Reasoning Was Flawed.

In ruling in favor of IPL, the Tax Court below looked at all the facts and circumstances to see if the primary purpose of the deposits was to serve as an advance payment. Because IPL always treated the deposits as liabilities owed to customers, could apply deposits to bills only upon customer default, paid interest on the deposits and obtained deposits only from non-creditworthy customers, the Tax Court concluded that the primary purpose of the deposits was not the advance payment of electricity bills.

The Tax Court correctly concluded that the customer deposits received by IPL were not taxable upon receipt and properly looked to the degree of control that customers had over those deposits, rather than to the primary purpose test as devised by the Eleventh Circuit in *City Gas Co. of Florida* v. *Commissioner*, 689 F.2d 943 (1982). The court's analysis is in other respects, however, troublesome. As discussed in A., *supra*, when, as here, legal ownership of property is undisputed and acknowledged by the parties, ownership of income from property is irrelevant in determining tax ownership of the property itself. Furthermore, the only amounts whose treatment is at issue are the deposits actually paid. That relatively few

[11] When there is an issue as to whether the taxpayer is under a bona fide obligation to restore or account for amounts received, that the taxpayer pays interest may be evidence of such an obligation and of an intention to honor that obligation. *See Clinton Hotel Realty Corp.* v. *Commissioner*, 128 F.2d 968 (5th Cir. 1942).

of IPL's customers had to pay security deposits is irrelevant in determining whether those deposits that were paid are taxable upon receipt. Even if one accepts the premise that bona fide deposits applicable to payment obligations upon customer default can be advance income under certain circumstances, that the taxpayer does not secure deposits from all customers and the reason for such restraint seems quite beside the point.

Because the Tax Court below characterized the proper test as whether the "primary purpose" of the deposit was an advance payment of income, adoption of the Tax Court's standard would lead to confusion in application of the law. The seeds of such confusion were sown in the court's opinion itself. The court attempted to distinguish the instant case from the facts in *Oak Industries, Inc.* v. *Commissioner*, 52 T.C.M. (CCH) 1556 (1987), which had been decided three months earlier.[12] In attempting to distinguish *Oak Industries*, the Tax Court below cited four factors, only two of which—the payment of interest and the proportion of customers charged a deposit—the court had discussed in reaching its decision in favor of respondent.

The court's invocation of the other two factors was highly questionable. First, the court noted that, in *Oak Industries*, between 61 and 70 percent of customers had at least some of their deposits credited against delinquent payment obligations. Use of this as a distinguishing factor is somewhat puzzling since between 57 and 69 percent of all deposits returned by respondent were in the form of credits against bills for utility service.[13] The

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[12] *Indianapolis Power and Light Co.* v. *Commissioner*, 88 T.C. 964, 978 n.6 (1987).

[13] 88 T.C. at 969. See also Burke and Friel, *Tax-Free Security: Reflections on* Indianapolis Power & Light, 12 Rev. Tax'n Individuals 157, 172-73 n.67 (1988).

Tax Court also noted that the subscription television service involved in *Oak Industries* had a well-developed delinquent account collection system. Yet, in its opinion in *Oak Industries*, the court said that the taxpayer's "reliance on other collection devices in addition to the requirement of a deposit merely underscores petitioners' concern for the return of the decoders and has little relevance in ascertaining the primary purpose of the deposit." *Id.* at 1561.

III. THE PRIMARY PURPOSE TEST EMPLOYED BY THE COURT OF APPEALS FOR THE ELEVENTH CIRCUIT IN *CITY GAS CO.* FOR DETERMINING WHETHER A DEPOSIT IS PREPAID INCOME IS SERIOUSLY FLAWED.

The Eleventh Circuit in *City Gas Co. of Florida* v. *Commissioner*, 689 F.2d 943 (11th Cir. 1982), *rev'g* 74 T.C. 386 (1980), employed what it termed a primary purpose test for determining whether customer deposits were taxable upon receipt. Under this test, a payment denominated as a security deposit is treated as prepaid income if the primary purpose for the deposit, as determined by examining all the facts and circumstances, is to *secure* the payment of an income obligation.

The underlying premise of this primary purpose test is that a deposit given primarily to secure the payment of an income item is prepaid income. To accept this premise is to ignore the economic and legal distinctions between a security deposit and prepaid rent or fees. A deposit that is not automatically applicable to future rent or fee obligations is not the equivalent of prepaid income because the recipient's net worth does not increase upon receipt of such a deposit. Furthermore, a deposit that is not automatically applicable to future rent or fee obligations has non-tax legal consequences that are significantly different from prepaid rent or fees.

A. The Primary Purpose Test Does Not Distinguish Between Deposits that Are Equivalent to Prepaid Income and Deposits that Are Not Equivalent to Prepaid Income.

Even leaving aside the economic and legal distinctions between a bona fide security deposit and a prepayment, the primary purpose test is fundamentally flawed. Given the universal agreement of the courts and the Service that a deposit that primarily secures the performance of a customer's non-income covenants is not taxable upon receipt, the primary purpose test makes little sense in determining whether a deposit is in effect prepaid income.

As the court of appeals below recognized, there is no sound basis for according different tax treatment to a deposit that secures the payment of income and a deposit that secures the performance of non-income covenants. When a deposit is forfeited to the taxpayer, that deposit either prevents a loss of gross income (when it secures an income covenant), prevents a reduction in net income by avoiding a casualty or theft loss (when it secures the return of property in good condition) or generates a taxable windfall (when it serves as liquidated damages to compensate for lesser or non-economic damages from breaches of non-income covenants). In any of those situations, application of the deposit increases the taxable income of the taxpayer over what it would have been in the absence of the deposit.[14] On the other hand, when a deposit is obtained but returned to the customer, there has been no accession to the taxpayer's wealth whether the deposit secures income or non-income covenants.

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[14] The court of appeals in *Indianapolis Power and Light*, 857 F.2d at 1167-68 n.9, expressed this in another way with regard to the consequences flowing to an accrual basis taxpayer (which must include rent or fees in income when due, even if not paid). In that situation, the application of a deposit even to an income obligation avoids a taxable loss. Without the deposit, the taxpayer would be entitled to a deduction for the unpaid rent or fee.

B. The Primary Purpose Test Is Virtually Impossible To Apply in a Useful Manner.

As a practical matter, the *City Gas* primary purpose test is of little utility in distinguishing between true deposits and prepaid income. When a deposit secures solely a customer's obligation to make rent or fee payments, the test is no more than a *per se* rule of income inclusion. When a deposit secures the performance of both income and non-income covenants, such a test is either extremely difficult to administer[15] or poses elusive and almost insurmountable burdens for taxpayers to overcome in proving that the dominant purpose is to secure the performance of non-income covenants.

Even if the initial or primary reason for charging a deposit is to secure the performance of non-income covenants, every prudent taxpayer that has sufficient bargaining power to exact a "deposit" will ensure that it can also be used as security against non-payment. Thus, in the typical situation in which a deposit secures the performance of non-income covenants, the primary purpose test is virtually impossible to employ in any consistent way because the test requires weighing the importance of different functions as they relate to different covenants. To the extent that it secures the performance of non-income covenants, a deposit serves an incentive or deterrent function (*i.e.*, to make a customer act, or refrain from acting, in a certain way). On the other hand, to the extent that it secures against the breach of income covenants, a deposit is not designed to affect customer behavior but serves simply to avoid difficulties in collection. Although one might be able to quantify how often a collection function is employed, taxpayers, who have the

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[15] Application of the test results in virtually identical payments being treated differently on the basis of some artificial reading of the relative weight the parties give to their "intentions".

burden of proof,[16] are hard-pressed to demonstrate how often a deterrence function is used and are subject to a difficult burden in showing that an incentive function is served (*i.e.*, the taxpayer would have to show that those customers who took the desired action would not have done so without the deposit). Moreover, once the efficacy of each function is measured, the importance of each goal to the taxpayer must be weighed before any assurance can be given that the "primary purpose" has been established.

The practical difficulty in applying the primary purpose test is well illustrated by the Tax Court's application of that test in *Oak Industries, Inc.* v. *Commissioner*, 52 T.C.M. (CCH) 1556 (1987), which involved the proper treatment of deposits that secured customer obligations both to return in working order subscription television decoder boxes and to make monthly payments for subscription television service. Although the court accepted the taxpayer's testimony that return of the decoder boxes was critical to its business, the court concluded that the primary purpose for the deposits was to secure the monthly payments. In reaching this conclusion, however, the court made no attempt to evaluate the importance or likely efficacy of the deposits in securing the undamaged return of the decoder boxes or why the decoder box return purpose was any less important than the subscription fee collection purpose. The court merely pointed to the fact that the deposits were in many cases used to offset delinquent customer accounts.

C. The Primary Purpose Test Is Contrary to Legal Principles Governing the Receipt of Funds with an Acknowledged Liability to Return.

The Eleventh Circuit's primary purpose test conflicts with the weight of authority. No case prior to that court's decision in *City Gas* treated as income deposits that were not automatically applicable to rent or fee ob-

[16] *See, e.g.*, Rule 142(a) of the Tax Court Rules of Practice and Procedure.

ligations.[17] The Eleventh Circuit's test is also inconsistent with settled law regarding the tax treatment of escrow deposits by installment basis sellers. The issue of whether, under the installment sale reporting rules, an escrow deposit to secure both payment of purchase price installments and the seller's covenants regarding the property sold constitute "payment" under Internal Revenue Code section 453, is closely analogous to the issue presented here. No court has ever applied the primary purpose test in these cases. *See Sprague* v. *United States*, 627 F.2d 1044 (10th Cir. 1980); *Bassett* v. *Commissioner*, 33 B.T.A. 182 (1935), *aff'd per curiam*, 90 F.2d 1004 (2d Cir. 1937).

IV. THE MOST APPROPRIATE STANDARD FOR DETERMINING WHETHER A DEPOSIT THAT SECURES THE PERFORMANCE OF AN INCOME COVENANT IS PREPAID INCOME IS WHETHER THE RECIPIENT HAS CONTROL OVER THE RETURN OF THAT DEPOSIT.

Petitioner takes the position that a deposit to secure the payment of future rent or fees is essentially the same as a prepayment of such rent or fees and therefore should be taxed in the same manner. That position, however,

[17] Indeed, the Eleventh Circuit appears to have misconstrued the cases on which it purported to rely. The court, 689 F.2d at 946-47, invoked three cases and Rev. Rul. 72-519 as setting forth the primary purpose test. However, one of those cases, *Mantell* v. *Commissioner*, 17 T.C. 1143, 1148 (1952), and Rev. Rul. 72-519, 1972-2 C.B. 32, 33, explicitly limit the primary purpose test to situations in which a purported deposit is automatically applicable to rent or fee obligations. The other two cases, *Hirsch Improvement Co.* v. *Commissioner*, 143 F.2d 912, 915 (2d Cir. 1944), and *Gilken Corp.* v. *Commissioner*, 10 T.C. 445, 454 (1948), as well as all three Fifth Circuit precedents that the Eleventh Circuit found to be "consistent with" its primary purpose analysis, *Van Wagoner* v. *United States*, 368 F.2d 95 (5th Cir. 1966); *Astor Holding Co.* v. *Commissioner*, 135 F.2d 47 (5th Cir. 1943), and *Clinton Hotel Realty Corp.* v. *Commissioner*, 128 F.2d 968 (5th Cir. 1942), also involved purported deposits that were automatically applicable to rent or insurance premium obligations.

ignores two fundamental principles governing the administration of the internal revenue laws—that a prerequisite to taxable income is an accession to the taxpayer's wealth and that the Commissioner is not free to recast transactions the form of which comports with their substance. That position is also inconsistent with more than 60 years of authority on the proper federal income tax treatment of customer deposits. When the taxpayer is under a bona fide obligation to refund a deposit if the customer fulfills the obligations to which he has agreed, that deposit is not income upon receipt.

A. A Deposit that Is Not Automatically Applicable to Future Rent or Fees Does Not Represent an Accession to the Recipient's Wealth.

Although superficially plausible, petitioner's comparison of the deposits received by IPL with prepaid income of the type deemed taxable upon receipt in *American Automobile Ass'n* v. *United States*, 367 U.S. 687 (1961), *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180 (1957), and *Schlude* v. *Commissioner*, 372 U.S. 128 (1963), is fundamentally erroneous. In those cases, this Court ruled that amounts received by accrual method taxpayers for future services were taxable upon receipt, even though they would not be accrued in the traditional accounting sense until the services were performed.

Unlike bona fide deposits, such as those involved in the instant case, prepayments of the type involved in the cited cases satisfy both the wealth accession and realization requirements. The receipt of a prepayment for services or rent increases the recipient's assets and is offset only by the recipient's liability to provide services or the use of property—a liability that, even when satisfied, does not reduce the recipient's net worth.[18] Thus, receipt

[18] Because the liability to return prepayments if the services or property use is not provided is a contingent liability, it does not offset the receipt of funds. *See supra* note 2.

of an advance payment increases the recipient's net worth by the amount of the payment. So long as the prepayment is in the form of cash or a cash equivalent, its receipt also satisfies the realization requirement.

Similarly, if an amount denominated as a deposit is, by the terms negotiated by the parties, automatically or at the taxpayer's option applied to future rental or fee obligations regardless of the customer's compliance with all covenants secured by the deposit, there is an accession to the taxpayer's wealth upon receipt because the taxpayer has no real obligation to repay the amount. By agreeing that the taxpayer may retain the deposit simply by doing what he has otherwise agreed to do, the parties have "intended" that the deposit serve as payment. As in the case of a purported loan that is legally enforceable but which the parties have no intention or ability to enforce, and as in the case of funds that are extorted or embezzled, an accession to wealth can reasonably be assumed. In such a case, the customer has in effect ceded to the taxpayer control over the deposit at the time of payment.

In contrast, a customer retains control over the disposition of a bona fide deposit that is not automatically applicable to future rent or fee obligations. Such a deposit, therefore, does not—and cannot be assumed to—increase the receipient taxpayer's net worth. The increase in cash assets represented by the amount deposited is associated not only with an obligation to provide future services or the future use of property but also with a liability, which the parties fully intend and expect to be honored, to return the deposit upon customer satisfaction of all covenants secured by the deposit. That latter liability does offset the increase in the taxpayer's cash assets. Thus, although receipt of the deposit would be a realization event, the required accession to wealth is absent. That accession occurs only if and when the customer defaults in its rent or fee obligation and the taxpayer's liability is extinguished.

B. A Deposit that Is Not Automatically Applicable to Future Rent or Fee Obligations Generates Fundamentally Different Non-tax Legal Consequences than Prepaid Rent or Fees.

Petitioner contends that a deposit to secure customer performance of an income covenant is indistinguishable from an advance payment, and thus is taxable on receipt as prepaid income. This position ignores the fact that the parties' common law rights and obligations with respect to a bona fide deposit to secure customer performance are significantly different from their rights and obligations with respect to a rent or fee prepayment. Moreover, whether a payment is designated as a deposit or as a prepayment may affect the rights of third parties.

In the case of a lease of real property,[19] a landlord holding a security deposit has an obligation to return it in the event that the lease is terminated without fault, and to return any amount of the deposit that is in excess of any damages caused by the tenant's breach of the obligations secured by the deposit. *See, e.g., Redmon* v. *Graham*, 211 Cal. 491, 295 P. 1031 (1931). On the other hand, a landlord who holds a sum specifically designated as prepaid rent may keep such amount upon termination of the lease, unless the termination is unlawful against the tenant. *See Friedman* v. *Isenbruch*, 111 Cal. App.2d 326, 244 P.2d 718 (1952); *Housholder* v. *Black*, 62 So.2d 50 (Fla. 1952); *Sinclair* v. *Burke*, 133 Or. 115, 287 P. 686 (1930). Similarly, the obligation to return a security deposit is personal to the landlord, but rent prepaid unconditionally inheres in the leasehold estate. Thus, the benefit of prepaid rent, unlike a security deposit, survives

[19] We have found no authority discussing the common law consequences of a deposit, as opposed to an advance payment for goods or services, in a personal property context. Presumably, a court would refer by analogy to landlord-tenant law in analyzing a fact pattern involving personalty, since it is there that the law has developed.

conveyance of the leasehold. See *Mantell* v. *Commissioner*, 17 T.C. 1143, 1148 (1952), *acq.*, 1952-1 C.B. 3.

There is also at common law a distinction between a deposit that is automatically applied to rent and one that is security for rental payments but is returned upon the tenant's fulfillment of its rental obligations. When a security deposit is, by the terms of the parties' agreement, to be applied to the last months' rent, payment of that deposit is treated as satisfaction of the tenant's rental obligation (provided the lessee is not in default). *In re Riviera Club*, 280 F. Supp. 741 (W.D. Mo. 1967), *aff'd sub nom. Aylward* v. *Broadway Valentine Center, Inc.*, 390 F.2d 556 (8th Cir.), *cert. denied*, 391 U.S. 964 (1968); *Sidman* v. *Washington Square Realty Corp.*, 408 N.Y.S.2d 988, 95 Misc.2d 825 (1978).

Moreover, in contrast to a bona fide deposit, such a deposit is not recoverable by the tenant in default (or its trustee in bankruptcy) even if the default occurs prior to the period for which the deposit was to be applied as rent. *See In re Riviera Club, Inc.*, 280 F. Supp. 741 (W.D. Mo. 1967) (interpreting Missouri law), *aff'd sub nom. Aylward* v. *Broadway Valentine Center, Inc.*, 390 F.2d 556 (8th Cir.), *cert. denied*, 391 U.S. 964 (1968); *Zaconick* v. *McKee*, 310 F.2d 12 (5th Cir. 1962) (interpreting Florida law); *see also Sline Properties, Inc.* v. *Colvin*, 190 F.2d 401 (4th Cir. 1951) (interpreting Maryland law). That is not the case when a deposit is returnable shortly after satisfaction of the rental obligation that such deposit secures.

C. The Superficial Economic Equivalence Between Deposits that Secure Income Covenants and Prepaid Income Is Not a Proper Basis for Taxing Bona Fide Deposits Upon Receipt.

Petitioner emphasizes, and the court of appeals appears to concur, that a deposit securing a customer's obligation to pay rent or fees is, from a cash flow standpoint, no different than a deposit automatically applicable to a

portion of the rent or fee due. In the former case, once the income covenant is satisfied, the deposit may be returned *pro tanto*. Although equating the two situations is superficially plausible, close examination reveals substantial differences between them.

It should be emphasized initially that even the superficial similarity between a deposit automatically applied to rent or fees and a deposit that secures income covenants evaporates *to the extent* that the latter secures any bona fide non-income covenant—even if the "primary purpose" of the deposit is to secure income covenants. To the extent that a deposit secures a non-income covenant that extends beyond the time for the final rent or fee payment—which is typically the case when a deposit secures against damage to or loss of leased property—the deposit is not returned upon payment of the final rent or fee payment that it also secures, but only upon discharge of the non-income obligation.[20]

Moreover, even if a deposit secures solely a customer's payment obligation and can be returned upon satisfaction of such obligation, there is—in the absence of a sham arrangement—no basis for treating it the same as a deposit that is automatically applied to a payment obligation when it becomes due. The "economic equivalence" asserted by petitioner is a purely cash flow equivalence and ignores the unquestioned legal liability to repay that is incurred by a deposit recipient, but not by a prepay-

[20] In this respect, it is instructive to review the facts in *Oak Industries, Inc.* v. *Commissioner*, 52 T.C.M. (CCH) 1556 (1987), to our knowledge the only case in which a customer deposit that secured a significant non-income covenant throughout the parties' relationship was held to be taxable upon receipt. In that case, even if the customer fully paid all of its monthly subscription fee obligations on time, the customer's deposit was not returned—either upon receipt of the final month's fee or even upon termination of service—until the taxpayer had received the television decoder box and had determined that the box was not damaged and had not been tampered with. In such a case, the customer's final fee payment is never matched by the return, shortly thereafter, of its deposit.

ment recipient. In this regard, IPL is no more in an economically equivalent position to one who receives prepaid income than is a rental property owner whose mortgage is secured by rents from the property.[21] As has been noted, different common law consequences attach to a bona fide deposit than attach to a prepayment.

Finally, when there is no meaningful difference between a deposit, returnable upon satisfaction of the obligation, that secures solely a customer's payment obligation and a deposit that by its terms is applied to rent or fee payments, the Commissioner has ample authority to look to the substance of the transaction.[22] If the parties do not intend to enforce the obligation to return a deposit, the legal liability should be ignored and the deposit treated as prepaid income.[23] But, given the substantial economic

[21] Petitioner's "economic equivalence" approach, if adopted, would radically broaden the reach of the income tax laws. For example, financial institutions that required borrowers to maintain compensating balances on deposit as security for principal and interest payments would have to recognize at least some interest income at the time of loan origination. *See* Seago, *Recent Cases Focus on When Deposits Are Includible in Income*, 70 J. Tax'n 38, 40 n.3 (1989). Moreover, because a substantial portion of customer deposits of the type received by respondent are returned to the customer, *see AT&T* v. *Commissioner*, 55 T.C.M. (CCH) 16, 20 (1988), taxing such deposits as income upon receipt would yield the anomalous result that close to half, and sometimes more than half, of such "income" would have to be reversed eventually.

[22] *See Oden* v. *Commissioner*, 56 T.C. 569 (1971); *Pozzi* v. *Commissioner*, 49 T.C. 119 (1967), in which escrowed funds intended by the parties from the beginning to constitute consideration, and not merely security, for property sales were treated as amounts realized by the seller upon receipt.

[23] *See August* v. *Commissioner*, 17 T.C. 1165 (1952), in which a security deposit that was not by its terms automatically applicable to rent was treated as prepaid rent. The initial lease between the parties provided that the deposit was automatically applicable to the last months' rent. The lease was modified at the landlord's insistence for tax purposes to provide that the deposit was not so

and common law differences between a bona fide deposit and a prepayment, the Commissioner's authority should not extend further.

D. The Control Test Is Most Consistent with Prior Case Law Regarding the Taxation of Customer Deposits.

Until the Eleventh Circuit's decision in *City Gas*, the vast majority of courts that considered the taxability of customer deposits concluded that, if the taxpayer had a bona fide obligation to return a deposit so long as the customer honored all of its covenants, that deposit was not taxable to the recipient until actually forfeited. *See Boston Consolidated Gas Co.* v. *Commissioner*, 128 F.2d 473 (1st Cir. 1942); *Warren Service Corp.* v. *Commissioner*, 110 F.2d 723 (2d Cir. 1940); *City Gas Co. of Florida* v. *Commissioner*, 74 T.C. 386 (1980); *Mantell* v. *Commissioner*, 17 T.C. 1143 (1952), *acq.*, 1952-1 C.B. 3. On the other hand, when an amount denominated as a deposit is automatically or at the taxpayer's option applied to discharge customer payment obligations, the courts have treated the amount as a prepayment. *See Hirsch Improvement Co.* v. *Commissioner*, 143 F.2d 912 (2d Cir. 1944); *Astor Holding Co.* v. *Commissioner*, 135 F.2d 47 (5th Cir. 1943); *Commissioner* v. *Lyon*, 97 F.2d 70 (9th Cir. 1938); *Gilken Corp.* v. *Commissioner*, 10 T.C. 445 (1948), *aff'd*, 176 F.2d 141 (6th Cir. 1949); *J. and E. Enterprises, Inc.* v. *Commissioner*, 26 T.C.M. (CCH) 944 (1967).[24]

This judicially-recognized dichotomy between the treatment of customer deposits that secure against the non-

applicable, but the tenant continued to act as if it were, and payment of the last months' rent occurred simultaneously with the return of equal amounts of the deposit.

[24] *But see Clinton Hotel Realty Corp.* v. *Commissioner*, 128 F.2d 968 (5th Cir. 1942), in which a deposit applicable by its terms to rent was held not to be taxable upon receipt where the taxpayer paid interest on it.

payment of future income obligations and deposits that are automatically applied against those obligations fully comports with the principles governing the administration of the tax laws. Taxing a deposit only when the customer has ceded ultimate control of it to the taxpayer is consistent with the principle that taxable income can arise only when there has been an accession to wealth. If the taxpayer is accountable for the amount deposited so long as the customer fulfills all of its obligations, the taxpayer has a liability that offsets the increase in its cash assets. When the taxpayer is not accountable for the amount deposited even if the customer fulfills all of its obligations, on the other hand, no such offsetting liability can be said to arise.

Taxing deposits upon receipt only when the taxpayer may retain them even if the customer fulfills all of its obligations also gives effect to an arm's-length agreement that has significant non-tax consequences. True deposits that secure the payment of future rent or fees may not be retained by lessors or service providers except to the extent of damages caused by actual breaches of the rent or fee covenants. On the other hand, prepaid rent or fees—which, under common law, include amounts denominated as deposits but that are automatically applicable to rent or fee obligations—may be retained by the lessor or service provider without having to account to the lessee or customer.

The principles advocated herein are aptly illustrated by the Tax Court's decision in *Mantell* v. *Commissioner*, 17 T.C. 1143 (1952). In *Mantell*, the taxpayer leased a hotel for 10 seasonal years beginning in 1946. In that year, he received $33,320 as security for all of the tenants' obligations, including monthly rental payments and various property covenants.[25] The deposit was not to be

[25] Although the court characterized some of the property covenants as "unusual", 17 T.C. at 1149, the vast majority of them appeared to be standard covenants covering the return of the

applied to rent except on the tenants' default. The taxpayer was not required to pay interest on the deposit. Two days after each of the final five rental payments was due, equal amounts of the deposit were to be returned to the tenants if they had fulfilled their obligations.[26]

The Commissioner sought to tax the deposit upon its receipt in 1946, claiming that it served as prepaid rent. The Tax Court rejected this argument, noting that the parties' agreement "expressly provid[ed] that the deposit was not to be applied to rent" and called for return of the deposit upon termination of the lease. The court took note of "the relationship in time and amount" between the final rent obligations and return of the deposit, but dismissed the significance of that relationship because the common law distinction between a deposit and a rent prepayment gave substance to the parties' agreement for tax purposes. The court concluded:

> [W]e cannot conclude [from the relationship between the last months' rent and return of the deposit] as does [the Commissioner] that the provision for the repayment of the security deposit to the lessees lacked substance and was in fact a provision for the prepayment of rent. Such an express provision cannot easily be disregarded when, as here, the legal rights of the parties, and of third parties also, may be substantially different depending on whether the clause provides that the deposit is to be returned to the lessees or applied to the rent for the final period.

Id. at 1148. It is noteworthy that petitioner has acquiesced in the Tax Court's decision in *Mantell* for more than 35 years. 1952-1 C.B. 3.

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premises and furnishings in good condition, prevention and removal of liens on the property, and payment of insurance, taxes and license fees. *Id.* at 1147.

[26] In 1949, the lease was modified to a five seasonal year lease with revised rental payments. The deposit was retained but was to be returned *pro tanto* four days after the receipt of certain rent payments in the final year. In fact, $14,000 of the deposit was applied to rent following the tenant's default.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted,

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AMICUS CURIAE

BRIEF

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No. 88-1319

IN THE

Supreme Court of the United States

OCTOBER TERM, 1989

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

v.

INDIANAPOLIS POWER AND LIGHT COMPANY,

Respondent.

On Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

BRIEF FOR WISCONSIN ELECTRIC POWER COMPANY AND AFFILIATED COMPANIES AS AMICUS CURIAE IN SUPPORT OF THE RESPONDENT

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QUESTION PRESENTED

Are customer deposits required by a public utility to secure the payment of future bills income to the utility upon receipt?

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Respondent.

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BRIEF FOR WISCONSIN ELECTRIC POWER COMPANY AND AFFILIATED COMPANIES AS AMICUS CURIAE IN SUPPORT OF THE RESPONDENT

INTEREST OF AMICUS CURIAE

Wisconsin Electric Power Company and affiliated companies ("WEPCO") submit this brief with the written consent of the parties. Copies of these consents are being filed herewith.

WEPCO is a regulated public utility principally engaged in the production, distribution and sale of electricity and natural gas. To protect itself from bad debt losses, WEPCO collects security deposits from a small percentage of its customers subject to procedures established by an order of the Public Service Commission of Wisconsin. Customers are annually notified in writing of all deposit rules, payment options, disconnection procedures, and dispute procedures. WEPCO pays interest on customer deposits, currently at the rate of 8%, from the date of deposit. Only when a customer fails to pay a bill on a timely basis are deposits charged to the unpaid bill. The balance is refunded. Between 63% and 79% of the deposits are refunded by check. The deposits are treated as liabilities for financial, regulatory, and tax reporting purposes.

WEPCO is a party to *Wisconsin Electric Power Company and Affiliated Companies v. Commissioner*, Docket No. 4221-89, currently pending before the United States Tax Court and appealable to the Court of Appeals for the Seventh Circuit. The issue involved in that case, WEPCO's tax treatment of customer deposits, is very similar to the issue presented here.

STATUTORY PROVISIONS INVOLVED

The complete text of Section 451(f) of the Internal Revenue Code (26 U.S.C.) reads as follows:

(f) SPECIAL RULE FOR UTILITY SERVICES.—

(1) IN GENERAL.—In the case of a taxpayer the taxable income of which is computed under an accrual method of accounting, any income attributable to the sale or furnishing of utility services to customers shall be included in gross income not later than the taxable year in which such services are provided to such customers.

(2) DEFINITION AND SPECIAL RULE.—For purposes of this subsection—

(A) UTILITY SERVICES. The term 'utility services' includes—

(i) the providing of electrical energy, water, or sewage disposal,

(ii) the furnishing of gas or steam through a local distribution system,

(iii) telephone or other communication services, and

(iv) the transporting of gas or steam by pipeline.

(B) YEAR IN WHICH SERVICES PROVIDED.—The taxable year in which services are treated as provided to customers shall not, in any manner, be determined by reference to—

(i) the period in which the customers' meters are read, or

(ii) the period in which the taxpayer bills (or may bill) the customers for such service.

SUMMARY OF ARGUMENT

The issue presented in this case is whether customer deposits securing the future payment of utility bills are includable in gross income as advance payments in the year of receipt. The legal analysis which is applied in these cases is to review the facts and circumstances of the deposit to determine whether the deposit serves as an advance payment of income or as security for future performance. In the present case, the Seventh Circuit Court of Appeals properly applied this analysis and upheld a unanimous Tax Court decision which found that security deposits received by Indianapolis Power and Light Company did not represent advance payments.

The holding of the Seventh Circuit Court of Appeals is in accordance with this Court's definition of gross income. In *James v. United States*, 366 U.S. 213 (1961), this Court ruled that a taxpayer recognizes gross income only when it receives amounts without recognition of an obligation to repay and without restriction as to their disposition. Accordingly, in applying the facts and circumstances test, the lower courts have appropriately given substantial weight to the customer's right to refund and the taxpayer's corresponding recognition of a duty to refund.

The Commissioner has attempted to dissuade the Court from using the facts and circumstances test by labeling it unworkable and discounting many of the factors which the various courts have considered in determining the proper tax treatment of customer deposits. The Commissioner proposes replacing the facts and circumstances analysis with a rule of law hinged on a single fact: whether customer deposits secure the future payment of bills or future nonmonetary conduct.

However, the Commissioner's dissatisfaction with each individual factor considered by the courts only emphasizes the need to review a deposit in light of the total facts and circumstances. A determination based on a single factor would be arbitrary. Further, adoption of the Commissioner's proposed test would not result in judicial or administrative convenience or alleviate the need to review facts and circumstances. The focus of the facts and circumstances test would merely shift to the type of conduct which is secured, a factor which is unrelated to the definition of gross income as enunciated by this Court.

In addition to the flaws noted above, the Commissioner's proposed test is inconsistent with prior case law. While the Commissioner relies heavily on the Eleventh Circuit Court of Appeals ruling in *City Gas of Florida v. Commissioner*, 689 F.2d 943 (11th Cir. 1982), the cases cited by the Eleventh Circuit in its decision do not prescribe a rule of law requiring deposits to be taxed as advance payments merely because the deposits secure the payment of future bills. In each of the cases cited by the Eleventh Circuit, the courts reviewed all of the facts and circumstances to determine whether the primary purpose of the deposit was to make an advance payment or to secure the performance of any covenant. There is no suggestion that nontaxable security deposits may only secure non-income producing covenants. Accordingly, the Tax Court has specifically refused to adopt the Commissioner's proposed test. In the present case, the court of appeals also declined to follow the Commissioner's proposed test. The Commissioner's proposed test is simply not supported by case law.

The Commissioner's proposed test is also not supported by economic substance. There is no economic distinction between deposits to secure the payment of future income

and deposits to secure property. Yet the Commissioner concedes that deposits to secure property are not taxable upon receipt.

A taxpayer receiving a deposit is in the same position whether the deposit secures property or future income. In both instances, the taxpayer has temporary use of the money but no ultimate right to retain it unless the depositor breaches a covenant. Upon receipt of the deposit, the taxpayer recognizes a liability to the depositor to refund the deposit upon performance of the covenant. Since, as the Commissioner concedes, a deposit securing property is nontaxable, the deposit securing future income should also be nontaxable.

In addition to distorting the economic realities of customer deposits, the Commissioner's proposed test will also distort income tax reporting. The Commissioner presents this as an issue of timing. However, this is not the case. Due to utilities' method of reporting income, inclusion of customer deposits in taxable income will result in double counting for income tax purposes.

The Commissioner's position is not supported by case law or economic substance and would result in distortion of income reporting for tax purposes. The Commissioner's position should not be followed.

ARGUMENT

1.

USE OF THE FACTS AND CIRCUMSTANCES TEST IS THE PROPER METHOD OF DETERMINING WHETHER CUSTOMER DEPOSITS ARE TAXABLE AS ADVANCE PAYMENTS.

(a) The Facts and Circumstances Test Has Been Applied by Numerous Courts Reviewing Taxation of Customer Deposits.

Numerous courts have addressed the question of whether a receipt constitutes a taxable advance payment or a nontaxable security deposit. The Tax Court has distinguished advance payments from nontaxable security deposits as follows:

> Advance payments to which a taxpayer-recipient has a present right, and over which he has unrestricted control, are income upon receipt, even though they are refundable under certain circumstances. (citations omitted.) If, on the other hand, an amount is deposited with a taxpayer as a security payment which is to be returned, it is not income, although the taxpayer has temporary use of the money. (citations omitted).

City Gas of Florida v. Commissioner, 74 T.C. 386, 391 (1980), *rev'd and remanded* 689 F.2d 943 (11th Cir. 1982) ("City Gas I"). *See also American Telephone and Telegraph Co. v. Commissioner*, 55 T.C.M. 16 (1988).

Courts have based their determinations of whether receipts constitute advance payments upon all of the facts and circumstances surrounding the receipt. In accordance with the standards set forth by the Tax Court factors of particular importance are whether or not the taxpayer had control of the deposit upon termination of the agreement

or a fixed duty to refund the deposit and whether interest was paid on the deposited amount.

In cases in which the taxpayer had no duty to refund the deposit and did not pay interest, the deposit has generally been considered a taxable advance payment. *See Gilken Corp. v. Commissioner*, 10 T.C. 445 (1948), *aff'd* 176 F.2d 141 (6th Cir. 1949); *Hirsch Improvement Company v. Commissioner*, 143 F.2d 912 (2d Cir. 1944); *Astor Holding Company v. Commissioner*, 135 F.2d 47 (5th Cir. 1943). In cases in which the depositor controlled disposition of the funds and the taxpayer paid interest on the deposit, the courts have generally ruled that the deposit was a nontaxable security deposit. *American Telephone and Telegraph Co. v. Commissioner*, 55 T.C.M. 16 (1988).

The court of appeals' ruling in this case is consistent with the facts and circumstances approach applied by the courts in the decisions cited above. The court of appeals noted that Indianapolis Power and Light Co. ("IPL") was legally required to refund customer deposits upon establishment of creditworthiness and was also required to pay interest upon those deposits. (Pet. App. 3a). Based upon these factors and others,[1] the court affirmed the Tax Court's determination that the deposit served as security and not prepayments of income. The court of appeals' decision was a correct application of existing precedent.

[1] In addition to recognizing IPL's duty to refund customer deposits upon establishment of creditworthiness and to pay interest upon those deposits, the court of appeals noted that only 5% of IPL's customers were required to make deposits; customers required to make deposits were selected by a credit test; the customer controlled the timing of the deposit refund; IPL treated the deposits as current liabilities at the time they were received, and unclaimed deposits escheated to the state. (Pet. App. 2a-4a).

(b) Use of the Facts and Circumstances Test is Consistent With This Court's Definition of Gross Income.

In addition to being supported by prior case law regarding customer deposits, the court of appeals' application of the facts and circumstances test is in accordance with this Court's definition of gross income. In *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955), this Court stated that gross income arose where there existed:

> Undeniable accessions to wealth, clearly realized, and over which the taxpayers [had] complete dominion.

Glenshaw Glass, 348 U.S. at 431.

In *James v. United States*, 366 U.S. 213 (1961), this Court expanded upon its definition of gross income and ruled that a taxpayer must recognize gross income when it receives amounts "without the consensual recognition, express or implied, of an obligation to repay and without restriction as to their disposition." *James*, 366 U.S. at 219. The lower courts' determinations regarding taxation of customer deposits are in accordance with these concepts of gross income since the factors given the most weight have been the customer's right to a refund, the taxpayer's corresponding recognition of a duty to refund, and the depositor's right to control the ultimate disposition of the deposit. *See Gilken*, 10 T.C. 445, *et al.* Commentators have recognized the importance placed by the courts upon the control factor:

> The only other factor that appears to have been accorded significant weight by the courts is the item the deposit secures. This factor, however, has not been consistently treated and clearly *is not as significant as the [taxpayer's] right to control the deposit.*

Burke & Friel, "Tax Free Security: Reflections on Indianapolis Power and Light," 12 Rev. Tax'n of Individuals,

157, 168 (1988) (emphasis added). Thus, the lower courts have appropriately emphasized the refund and control factors.

For example, in *J & E Enterprises, Inc. v. Commissioner*, 26 T.C.M. 944 (1967), the Tax Court reviewed the case of a taxpayer who had received a deposit under no obligation to refund and with the exclusive right to apply the deposit to a subsequent year's rent. *J & E Enterprises*, 26 T.C.M. at 945. Emphasizing the fact that repayment of the deposit was under the exclusive control of the taxpayer, the Tax Court ruled that the deposit was taxable as an advance payment. *J & E Enterprises*, 26 T.C.M. at 946. However, the court noted that:

> If, on the other hand, a sum is deposited to secure the lessee's performance under a lease, and is to be returned at the expiration thereof, it is not taxable income even though the fund is deposited with the lessor instead of in escrow and the lessor has temporary use of the money. (citations omitted.) In this situation the acknowledged liability of the lessor to account for the deposited sum on the lessee's performance of the lease covenants prevents the sum from being taxable in the year of receipt. (citations omitted.)

J & E Enterprises, 26 T.C.M. at 946.

Similarly, in *Astor Holding Company*, a landlord was required to include a "deposit" in gross income when pursuant to the terms of the lease the "deposit" specifically constituted part payment of the last year's rent. *Astor Holding Company*, 135 F.2d at 48. Again the failure to acknowledge an obligation to repay was significant.

The *James* repayment and restricted disposition criteria are also significant in the present case. At the time IPL receives a customer deposit it recognizes a fixed duty to

refund the deposit. IPL is required by the Public Service Commission of Indiana to treat the deposits as current liabilities on its books and inform utility customers that they will be entitled to a refund of the deposit provided that their bills are paid in a timely fashion. Thus, IPL has expressly recognized its duty to refund the deposit.

In addition to explicit recognition of its obligation to refund deposits, disposition of the deposits is under substantial restriction. The utility customer controls when and how a refund is made. At termination of service or upon establishment of creditworthiness, the customer may choose to have his deposit applied to his bill, refunded in cash, or refunded by check.[2] If a customer's bills are paid on a timely basis, his deposit is automatically refunded to him. If a customer fails to pay his bill when due, the customer effectively receives a refund through application of the deposit to his bill. If a deposit remains unclaimed, the deposit escheats to the State of Indiana under state law.

Since the utility acknowledges its obligation to repay and IPL has no control over the ultimate disposition of the funds, the customer deposits received by IPL cannot constitute taxable gross income under the rules announced by this court in *James* and *Glenshaw Glass*. Application of a facts and circumstances test which emphasizes the

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[2] The use of a credit mechanism rather than a cash or check refund does not reduce the utility's obligation to refund at the time the deposit is received. Further, both this Court and the Commissioner have previously recognized that crediting an amount to an individual's account is not significantly different than a cash payment for tax purposes. *Commissioner v. Hansen*, 360 U.S. 446 (1959); Rev. Rul. 72-519, 1972-2 C.B. 32 (Situation one). Accordingly, the use of a credit mechanism rather than a cash or check refund should not necessitate a different tax result.

refund obligation and control factors is consistent with these rules. In contrast, the Commissioner's proposed test would contradict this Court's definition of gross income and require recognition of taxable income despite the taxpayer's consensual recognition of the obligation to repay and the customer's control over the ultimate disposition of funds. Accordingly, the facts and circumstances approach should be retained.

(c) The Payment of Interest is a Proper Consideration When Determining Whether Customer Deposits are Taxable as Advance Payments.

The Commissioner contends that the court of appeals placed an undue emphasis on the existence of an interest obligation. Petitioner's Brief pp. 24-30. The Commissioner contends that the payment of interest is merely a reflection of the time value of money and should not impact the classification of a customer deposit as nontaxable security. Petitioner's Brief p. 28. However, this position contradicts the rule of law applied by the various lower courts and misinterprets the facts relied on by those courts.

The payment of interest has been consistently examined by courts analyzing the facts and circumstances of deposit transactions. The nonpayment of interest was a significant factor in each of the cases cited by the Commissioner in which the court found an advance payment. *See Von Wagoner*, 368 F.2d 95 (5th Cir. 1966); *Gilken Corp.*, 10 T.C. 445; *Astor Holding Company*, 135 F.2d 47; *Oak Industries, Inc. v. Commissioner*, 52 T.C.M. 1556 (1987); *J & E Enterprises*, 26 T.C.M. 944. In contrast, the courts have treated the payment of interest as a positive factor which is indicative of a nontaxable security deposit. *See Clinton Hotel Realty Corp. v. Commissioner*, 128 F.2d 968 (5th Cir. 1942); *City Gas I*, 74 T.C. 368. Thus, the

court of appeals properly included the payment of interest as a factor to be considered in determining whether or not customer deposits constitute taxable advance payments.

The Commissioner contends that the presence or absence of interest is irrelevant because it is merely a means of accounting for the time value of money and that "all deferred payment transactions include interest, either explicitly or impliedly." Petitioner's Brief p. 28. However, none of the cases cited by the Commissioner reveal such a time value adjustment. In fact, in *J & E Enterprises*, the facts of the case conclusively prove that no such adjustment was made. In *J & E Enterprises*, the taxpayer received a deposit which it could apply to the last year's rental under a 6-year lease agreement. The annual rental remained constant throughout the term of the lease. *J & E Enterprises*, 26 T.C.M. at 944. The depositor was not compensated for the time value of money through either interest payments or a reduction in the final years rent. An adjustment for time value was simply not made. Thus, while the Commissioner's proposition that the present value of money is accounted for in all deferral transactions may be supported by economic theory,[3] the facts of the advance payment cases decided by the lower courts do not indicate any such adjustment. Accordingly, the payment of interest is a valid consideration when determining whether a deposit constitutes a taxable advance payment.

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[3] The articles cited by the Commissioner in support of his time value theory merely *assume* that all deferred transactions include interest, impliedly or expiicitly. The time value concept is referred to as a "premise" which serves as a starting point for a purely theoretical discussion. Lokken, "The Time Value of Money Rules," 42 Tax L. Rev. 1, 11 (1986).

The deposit scenario is very similar to a loan. The taxpayer is required to pay the depositor interest for the period of time in which it holds the money. The taxpayer also repays the principal amount received either through issuance of a check or credit. In either case, the time value of money accrues to the customer in the form of interest at a rate determined and periodically adjusted by the Public Service Commission of Indiana. As in a loan situation, the deposits are available for the taxpayer's use only at a cost. The fact that the rate of interest paid does not reflect the market value at a given point in time does not convert the deposit into a taxable advance payment. There is no principle of law which would require a borrower to treat the principal amount as income merely because the market rate later exceeds the interest rate previously agreed upon. The obligation to pay interest at a rate determined by the Public Service Commission of Indiana clearly demonstrates that these deposits are liabilities akin to a loan and not taxable income.

(d) The Facts and Circumstances Test is a Practical and Workable Test.

The Commissioner attempts to dissuade this Court from adhering to the facts and circumstances test by discounting each of the factors considered by the Tax Court when determining the proper tax treatment of customer deposits. Petitioner's Brief pp. 30-34. The Commissioner refers to the facts and circumstances approach as a "non-test" which invites disparate treatment of identical customer deposit programs. Petitioner's brief p. 33. In reality, customer deposit programs are not identical. Thus, the failure to consider the facts and circumstances would result in unjust treatment.

In presenting his argument, the Commissioner ignores the fact that courts are quite adept at scrutinizing factual distinctions and are frequently called upon to review the facts and circumstances of the cases they must decide. For example, courts are often called upon to determine whether advances by stockholders to corporations constitute debt or equity. *See Bauer v. Commissioner*, 748 F.2d 1365 (9th Cir. 1984); *Stinnett's Pontiac Service, Inc. v. Commissioner*, 730 F.2d 634 (11th Cir. 1984). Additionally, courts frequently rule on whether or not corporate distributions to stockholders constitute loans or taxable income. *See Baker v. Commissioner*, 677 F.2d 11 (2d Cir. 1982); *Parks v. Commissioner*, 686 F.2d 408 (6th Cir. 1982). In the loan context, courts have specifically recognized that the existence of a loan should be determined upon "the total facts surrounding the creation and use of the instrument and not by its possession of some single characteristic." *Dunn v. Commissioner*, 615 F.2d 578, 584 (2d Cir. 1980).

Similarly, a determination of whether a deposit constitutes an advance payment should only be made after reviewing the total facts surrounding the deposit and the agreement of the parties. The Commissioner's dissatisfaction with each individual factor which the Tax Court considers only emphasizes the need to review a deposit in light of the *total* facts and circumstances. No single factor should be determinative.

Yet, in the present case, the Commissioner proposes a rule of law requiring deposits to be taxed as advance payments merely because they secure income producing covenants. While adoption of the Commissioner's myopic approach may decrease the possibility of disparate treatment, it will not result in a workable standard. Nor will it result in equity. The Commissioner's proposed test will

result in arbitrary classification of customers deposits as taxable advance payments. Taxation of customer deposits will depend on a single factor with all other pertinent factors excluded from consideration.[4] Such a standard cannot be adopted. Administrative convenience is not a proper basis for abandoning the economic substance of a transaction. Further, the Commissioner's approach will not result in administrative convenience.

Under the Commissioner's proposal, the courts must continue to review the facts and circumstances of each case. It is unrealistic to expect all deposits to fall neatly within the income producing or nonincome producing classifications. As the Commissioner and the Eleventh Circuit Court of Appeals have conceded, investigation of the facts and circumstances must continue in order to determine whether the primary purpose of the deposit was to prepay an income item or to secure performance of a nonincome producing covenant. *City Gas of Florida v. Commissioner*, 689 F.2d 943, 946 (11th Cir. 1982), *rev'g*, 74 T.C. 386 (1980); Rev. Rul. 72-519, 1972-2 C.B. at 33. In the past, a substantial number of the customer deposit cases have focused upon deposits securing both income and nonincome producing covenants. *See Clinton Hotel Realty Corp.*, 128 F.2d 968. Thus, the Commissioner's proposed test will not result in administrative or judicial convenience but will merely shift the focus of the facts and circumstances test and place an undue emphasis on classification of the covenants secured.

The Tax Court and the Seventh Circuit Court of Appeals properly rejected the Commissioner's arbitrary standard and have willingly and effectively applied the facts and circumstances test which the Commissioner claims to be unworkable. The Tax Court has specifically stated that it "should continue to examine all of the facts and circumstances surrounding a deposit to evaluate the rights retained by the depositor and the rights acquired by the holder of the deposit." (Pet. App. 34a). *See also American Telephone and Telegraph Co.*, 55 T.C.M. 16 (1988). The Seventh Circuit Court of Appeals in this case similarly held that customer deposits securing income need not necessarily be taxed as advance payments. (Pet. App. 11a). The Tax Court and the Seventh Circuit Court of Appeals obviously found the facts and circumstances test to be a workable method of determining whether or not customer deposits are taxable as advance payments.

[4] The factors considered by the Court of Appeals are described in Footnote 1.

2.

USE OF THE COMMISSIONER'S PROPOSED TEST IS NOT SUPPORTED BY PRECEDENT OR ECONOMIC SUBSTANCE.

(a) The Test Proposed by the Commissioner Incorrectly Assumes That a Deposit Securing the Payment of Future Bills is Equivalent to an Advance Payment of Such Bills.

The Commissioner devotes a substantial portion of his brief to reviewing the legal theory of advance payments. Petitioner's Brief pp. 12-16. There is no dispute that true advance payments are taxable upon receipt. However, customer deposits securing the future payment of bills are not advance payments.

The Commissioner relies heavily on the Eleventh Circuit Court of Appeals' ruling in *City Gas of Florida v. Commissioner*, 689 F.2d 943 (11th Cir. 1982), *rev'g* 74 T.C. 386 (1980) ("City Gas II"). In *City Gas II*, the Eleventh

Circuit held that the test to be applied in determining whether customer deposits received by a gas utility constitute taxable income is:

> [W]hether, under all the circumstances, the primary purpose of the payments at issue was a prepayment of income items, or whether the primary purpose was to secure the performance of nonincome producing covenants.

City Gas II, 689 F.2d at 948.

In developing this test, the Eleventh Circuit cited a number of cases.[5] However, none of these cases prescribe a rule of law requiring customer deposits to be taxed as advance payments merely because the deposits secure the payment of future bills. In each of these cases, the courts reviewed all of the surrounding facts and circumstances to determine whether the primary purpose of a deposit was to make a prepayment or to secure performance of *any* covenant in general.[6]

For example, in *Gilken*, 10 T.C. 445, the Tax Court addressed the taxation of payments which were to be applied to the last five months rental under a lease agreement. This agreement also permitted application of the payments toward the purchase price of the real estate in the event the tenant exercised an option to purchase the property. The court concluded that the primary purpose of the payment to Gilken was application of the deposit to the final five months of the lease. Accordingly, the court held that

[5] *See Von Wagoner*, 368 F.2d 95; *Hirsch Improvement Co.*, 143 F.2d at 915; *Astor Holding Co.*, 135 F.2d 47; *Clinton Hotel Realty Corp.*, 128 F.2d 968; *J & E Enterprises*, 26 T.C.M. 944 (1967); *Gilken Corp. v. Commissioner*, 10 T.C. 445 (1948); *Mantell v. Commissioner*, 17 T.C. 1143 (1952); et al.

[6] See citations at Footnote 5.

the deposit constituted a taxable advance payment. In rendering the decision, the court was guided by the following principles of law:

> [I]t is established that where payments are made merely as rent and made at the beginning of a lease, though for the final period thereof, they are, there being no other conditions, taxable as income at the time they are received. (citations omitted). . . . [I]f money is merely deposited by the lessee with the lessor, as *security for the performance by the lessee of the covenants and provisions of the lease, with no present right or claim of full ownership* by the lessor, the payment is not taxable to the lessor at the time of receipt, but when the happening of some event causes such deposit to become his property. (citations omitted).

Gilken, 10 T.C. at 451 (emphasis added).

There is no suggestion that the performance secured by the deposit must relate to nonincome producing covenants. Rather, a deposit securing performance of *any* covenant is sufficient. *See also Mantell*, 17 T.C. at 1148; *Hirsch Improvement Company*, 143 F.2d at 915.

Since a rule of law requiring deposits securing income producing covenants to be taxable as advance payments cannot be found in the case law preceding the Eleventh Circuit's decision in *City Gas*, the Tax Court has specifically refused to follow the Eleventh Circuit approach. The court of appeals in this case also refused to apply the Eleventh Circuit approach. These courts have correctly continued to apply the facts and circumstances analysis developed in prior case law.[7]

[7] The Tax Court has only applied the Eleventh Circuit test in cases directly appealable to the Eleventh Circuit. *See Gas Light Co. of*

(Footnote continued on following page)

The Commissioner is troubled by the court of appeals' recognition that advance payments and customer deposits are similar from a cash flow perspective. However, cash flow does not determine tax treatment. Taxpayers receive cash from a number of sources. Not all receipts of cash are taxable. For example, a taxpayer may receive funds under a loan agreement or a bond issue. In both instances, the taxpayer has use of the cash received but does not recognize income. The fact that a customer deposit securing the future payment of bill and an advance payment are similar from a cash flow perspective, does not mandate taxing the deposit as an advance payment.

(b) There is No Economic Distinction Between Deposits to Secure the Payment of Future Income and Concededly Nontaxable Deposits to Secure Property.

The Commissioner has acknowledged that deposits to secure the proper maintenance of property are not taxable upon receipt. Petitioner's Brief p. 13. Yet the Commissioner attempts to persuade this Court that deposits to secure the future payment of bills must necessarily be taxed upon receipt. Deposits to secure income do not differ economically from deposits to secure property and should be taxed in a uniform manner.

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[7] *continued*

Columbus v. Commissioner, 51 T.C.M. 685 (1986). The Tax Court has specifically declined to follow the Eleventh Circuit's test in *American Telephone and Telegraph Co.*, 55 T.C.M. 16 (1988) and in the case at bar. (Pet. App. 34a). The Tax Court continues to apply the facts and circumstances test in determining whether the customer deposit is intended to serve as an advance payment of income or as security for future performance. Similarly, the court of appeals' decision in this case was based upon an analysis of the facts and circumstances surrounding payment of the deposit. The court correctly ruled that a deposit to secure an income payment need not always be taxed as an advance payment. (Pet. App. 11a).

A taxpayer receiving a deposit securing the payment of bills is in the same economic position as a recipient of a deposit securing property. In both instances the recipient has the use of funds and the depositor is deprived of such use until the deposit is refunded. The fact that the recipient places the funds in its general accounts and has temporary use of the money is not determinative. A number of courts have ruled that sums deposited to secure performance under an agreement are not taxable income even though the recipient has temporary use of the money. *See Warren Service Corp. v. Commissioner*, 110 F.2d 723, *aff'g on this point and rev'd on another*, 39 B.T.A. 856; *Clinton Hotel Realty Corp.*, 128 F.2d 968; *Estate of George E. Barker*, 13 B.T.A. 562; *Virginia Iron, Coal and Coke Co.*, 37 B.T.A. 195, *aff'd* 99 F.2d 919, *cert. denied* 307 U.S. 630; *Mantell*, 17 T.C. 1143.

The recipient of a deposit to secure the future payment of income has no greater right to retain that deposit than the recipient of a deposit to secure the maintenance of property. In both instances the recipient's ultimate right to retain the deposit is controlled by the depositor's actions. The recipient of a deposit to secure property has no ultimate right to retain that deposit unless and until the property is damaged in breach of the agreement. Similarly, a recipient of a deposit to secure the payment of future bills has no ultimate right to retain the deposit unless and until the customer defaults in the payment of a bill. Thus, the depositor has ultimate control over disposition of the funds.

Yet the Commissioner contends that the duty to refund and the customer's control of the refund are not relevant. Petitioner's Brief, p. 20, citing *August v. Commissioner*, 17 T.C. 1165 (1952). The Commissioner contends that a

deposit to secure a future payment of bills must necessarily be taxed as an advance payment since a refund will be made only after the customer has paid his final bill, thus, resulting in an exchange of checks. However, this is incorrect. In many instances, the deposit is refunded prior to termination of service. As recognized by the Commissioner, IPL "refunded residential customers' deposits after timely payment for a period of either nine successive months or 10 out of any 12 consecutive months (provided that the two delinquent months were not consecutive), or if the customer subsequently satisfied the [utility's] credit test." Petitioner's Brief, p. 4. Therefore, IPL often did not hold a deposit at the time the customer terminated service. An exchange of checks could not occur.

In addition to placing undue emphasis on the potential exchange of checks, the Commissioner ignores the controlling facts in *August*. In *August*, the Tax Court refused to characterize the deposit as a security deposit because the original lease agreement described the payment as advance rent. The lease was later amended to reclassify the advance payment as a security deposit. The court ruled that the amendment did not affect the purpose for which the deposit was originally made and required the payment to be taxed as an advance payment. *August*, 17 T.C. at 1167. Thus, the facts and circumstances surrounding execution of the lease controlled. Similarly, the facts and circumstances surrounding the making of a customer deposit should control in deposit cases. If the purpose of the deposit is to secure the customer's performance of any covenant, the deposit should not be taxed as an advance payment. Classification of the deposit should not depend upon the type of covenant secured since deposits to secure the proper maintenance of property and deposits to secure the future payment of bills are not economically distinct.

(c) In the Case of Public Utilities, Taxation of Customer Deposits Upon Receipt would Result in Double Counting Income.

The Commissioner presents this issue as an issue of timing. It is not. The question is whether IPL should report income twice: once pursuant to its regular accounting method and again as a deposit. During the taxable years at issue, utilities generally reported income based on the meters read or bills issued method. These methods of accounting were long established methods, peculiar to utilities, which did not take into account any adjustments for cash flow. Thus, the utility took into income revenues based on meters read or the issuance of bills to customers. For tax years beginning after December 31, 1986, Section 451(f) of the Internal Revenue Code (26 U.S.C.) requires utilities to include in taxable income all income attributable to the furnishing of utility services at the time of furnishing the services.[8] Utilities account for income based upon the estimated services delivered to the customer at the end of the year. Thus for every customer, the utility has taken into income the amount of revenues which it will receive from that customer based on an estimate of services delivered to that customer through the end of the year.

The Commissioner contends that the utility must also take into income deposits made by that customer to secure the payment for these utility services. The Commissioner then suggests that an "adjustment" can be made when the deposit is either applied to the customer's account or refunded. The deposit, however, is income neutral. The income of the utility is calculated on a basis wholly

[8] The full text of I.R.C. § 451(f) is set forth at page 3 of this brief.

apart from cash received for services. Therefore the Commissioner's proposal has the effect of double counting income. This double counting is only corrected at the time the deposit is either applied to the customer's account or refunded to the customer.

Further, the utility will always receive a deduction regardless of the disposition of the deposits. If a deposit is applied to the customer's account, the utility will receive a deduction because under its prescribed method of accounting the utility has already taken into income the amounts outstanding on that account. If the deposit is refunded to the customer, the utility will also be entitled to a deduction. Because of the method of reporting income used by the utility, the requirement that customer deposits also be taken into income in effect creates a double taxation which is only corrected at the time of disposition of the deposit. The correction would always be a deduction because the income has been previously reported twice, once as a deposit and once under the utility's regular accounting method.

This situation is substantially different from that presented in the *Gilken* case. In that case, the taxpayer received a deposit which was to be applied to the last five months rental under a lease agreement. *Gilken*, 10 T.C. at 447. In that case, the taxpayer's reporting of the deposit as income would not result in double counting the income. The taxpayer would take the deposit into income. During the last five months of the lease term the taxpayer would merely record no income. Thus, for the taxpayer in *Gilken*, the declaration of the deposit in income was merely a matter of timing.

The general rule for taxable year of inclusion under § 451 of the Internal Revenue Code (26 U.S.C.) is that:

> The amount of any item of gross income shall be included in gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

I.R.C. § 451(a).

Clearly the utility's special method of accounting as set forth in § I.R.C. 451(f), dictates a different treatment of deposits for utilities. The Commissioner's position that deposits constitute additional income for tax purposes is inconsistent with I.R.C. § 451(f), and would result in double counting of income. The Commissioner's proposed rule must not be applied to utilities.

CONCLUSION

Customer deposits securing the payment of bills are not equivalent to an advance payment of such bills and should not be automatically taxed as such. The Commissioner's proposed rule of law requiring such deposits to be taxable upon receipt is not supported by precedent or economic substance and would be contrary to this Court's concept of gross income. In contrast, the court of appeals' application of a facts and circumstances analysis presents a workable solution which gives proper deference to this Court's rulings in *James v. United States*, 366 U.S. 213 (1961) and *Commissioner v. Glenshaw Glass*, 348 U.S. 426

(1955). Accordingly, the decision of the Seventh Circuit Court of Appeals should be affirmed.

Respectfully submitted,

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